TAXATION *FOR* PROSPERITY

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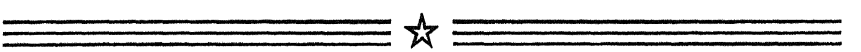
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Book One

TAXATION IN RETROSPECT

Chapter 1

THE SIXTEENTH AMENDMENT— A PEACEFUL REVOLUTION

1893-1913

It was 1893. The economic machinery was creaking noisily. Panic was in the air. Rumors of failure and reports of suicide filled the press. Regiments of embittered men and women walked the streets. Coxey's tattered army of unemployed was on the march to Washington. In Oregon discharged railroad workers joined the army. In Chicago striking Pullman Palace Car employees joined the union. Capital in the person of Mr. Pullman was recalcitrant and would not arbitrate. Governor Altgeld's protest to the contrary, President Cleveland sent Federal troops to Chicago. No one had protested the sending of troops to Buffalo the year before to curb a strike in the railroad shops. But Chicago was different. Violence soon exploded. Eugene Debs, the good-natured strike leader, who had spoken of "the battle between the producing classes and the money power of the country," was arrested for disobeying a blanket injunction issued by a Federal district judge, and Clarence Darrow entered upon his career of exonerating men from blame by spreading the mantle of fate as their charity. In Cleveland the plump fingers of a legendary Republican politician distributed dollar bills to shabby men on street corners, presaging the open hand with which he would soon make William McKinley the man of the hour.

The cyclonic young People's party was boiling in the West. Two years later a silver-tongued young man from Nebraska would offer free silver as a panacea in a Congress wrangling over tariffs and eager to tinker with the currency. But a skeptical country would prefer more conventional remedies. The time was not ripe for new things. The twentieth century was still around the corner.

Nor was the time ripe for the revolutionary eight-page tax statute, which became law on August 28, 1894, without receiving the President's signature. The *New York Tribune* said the Democratic hen had hatched a Populist chicken at last. Senator David Hill and many others called the act unconstitutional. Attack went to the Supreme Court in the Pollock case.[1] Despite the fact that England had had a century of experience off and on with income taxation, Mr. Joseph H. Choate, an eminent attorney, labeled the principles upon which the tax was defended "communistic, socialistic." Here words seemed momentarily to fail even the articulate Mr. Choate, but he continued—"what shall I call them—populistic as ever have been addressed to any political assembly in the world." The doctrine upon which the act was based was "worthy of a Jacobin club that proposed to govern France," or of "a Czar of Russia proposing to reign with undisputed and absolute power." In the opinion of this leader of the Eastern bar the act was "communistic in its purposes and tendencies" and "confiscatory." It was a "direct" tax upon property. It imposed a 2-percent tax upon income.

Although such a tax had been imposed during the Civil War, there was objection that it could not be done in 1894 without apportioning the proceeds among the states according to their population. In his argument Mr. Choate had said that under the old income tax law the four states of New York, Pennsylvania, Massachusetts and New Jersey paid four-fifths of the tax. The contention was that a prosperous state, such as New York with its many citizens with high incomes, should not be obliged to pay a "direct" tax, the proceeds of which would be disproportionately spent, for example, in Kansas.

The New York bar was not unanimous. Mr. James C. Carter was instructed by his client, the Continental Trust Company, ready "to submit itself without controversy or contention to the law of the country," to defend the validity of the tax to the best of his ability. He began with the "admitted truth" that governments must exact "large sums" from those who live under them, and set down as the first principle that taxes should be laid "according to the several and respective abilities of the people upon whom they are imposed to bear them." One departed from the rule of equality "in favor of the very poor." The

[1] Pollock *v.* Farmers' Loan and Trust Company, 157 U. S. 429 (1895), 158 U. S. 601 (1895).

rich, he said, generally succeeded in avoiding taxes, and "in every country and in every age the principal burdens of taxation have been borne by the poor." This was true in the United States where $500,000,000 was collected annually without regard for "ability to bear the burden." What, then, of the "monstrous form of injustice" argued by counsel for the appellant under which the income tax fell upon 2 percent of the population? Opposing learned counsel did not mention another "impressive and startling fact" which had been receiving more and more of the attention of the people. "I mean," said Mr. Carter, "the growing concentration of large masses of wealth in an ever-diminishing number of persons." The law was said to be "class legislation," and "to make a distinction between the rich and the poor." Certainly it was "class legislation" and "sectional legislation" too. That was its very object; that was "the very nature of an income tax"; if these arguments should be allowed to prevail, "it would be forever impossible for this country to lay any income tax whatever."

The wisdom and eloquence of Mr. Carter failed to carry the day; income taxation was postponed until the new century. In 1895 the Supreme Court, correcting a previous "century of error," declared the 1894 Act unconstitutional. The "wave of the socialist revolution" broke on the ultimate bulwark set up for the protection of our liberties. "Five to four the Court stands like a rock," declared the editor of the *New York Sun*. Others, including the *New York World*, disagreed. Gover-Altgeld compared the Pollock decision with the Dred Scott decision, and one of the dissenters—Mr. Justice Harlan—remarked that it gave to "aggravated wealth" a position of favoritism as objectionable as the dominion of the lawless.

A less appropriate simile for the way in which the Supreme Court invalidated the 1894 Act would be difficult to imagine. The original argument consumed five court days, from March 7 to 13; the reports devoted 111 pages to the arguments of counsel. In April Chief Justice Fuller's "Opinion of the Court," consisting of 32 pages, announced unanimity on only one argued question—whether the imposition of a tax upon income from state bonds was unconstitutional. The eight sitting judges agreed that it was, not because the tax was direct, but because the Federal Government lacked power to tax instrumentalities of the states.

A majority agreed that a tax on income from land was a direct tax.

Three other questions were before the court: (1) whether certain void provisions taxing rents from real estate invalidated the whole act; (2) whether the imposition of tax upon the income from personal property was unconstitutional as a direct tax; and (3) whether any part of the tax, if indirect, lacked uniformity. On these questions the court was evenly divided. Mr. Justice Field wrote a long concurring opinion expressing the view that the whole law of 1894 should be declared void. Mr. Justice White and Mr. Justice Harlan wrote dissenting opinions of considerable length.

On May 6 the Chief Justice announced that there would be a rehearing. The case was reargued for three days in May and on the twentieth, less than two weeks after the last day of reargument, the Chief Justice delivered a 5 to 4 opinion invalidating the entire act on the ground that a tax on income from real and personal property was a direct tax. At last the determined taxpayers had won. But their vindication was precarious. This time, Justices Harlan, Brown, Jackson and White dissented in separate opinions. Mr. Justice Jackson had been prevented by illness from hearing the original argument. Somebody who heard the first argument, probably Mr. Justice Gray, changed his mind. Certainly it was less than correct to say that the court stood like a rock.

There was comparative quiet along the Potomac for a dozen years after the Pollock decision. The *New York World* said that the income tax was "dead." But prophetically, the *World* added, "the principle upon which it is based is alive and will yet in some form prevail." Yet for a time the principle seemed without life. Other issues captured a shifting stage—free silver, antitrust legislation, government regulation of utilities and tariff reduction. The platforms of the radical political parties contained income tax planks in 1896, but Mr. McKinley was elected. In 1904 Mr. Bryan abandoned the tax in favor of a stronger antitrust plank in the Democratic platform.

From time to time voices sounded in the wilderness. In 1906 the unpredictable Theodore Roosevelt continued his vindication of John Morley's claim that the two most extraordinary things in America were Niagara Falls and Theodore Roosevelt. T. R. startled the Republicans by declaring himself in favor of a graduated income tax and a graduated inheritance tax, thus airing unorthodox views about leveling off the inequalities of fortune prevailing in the country. He attacked trusts, concentrated wealth and plutocrats in the passionate manner

of Mr. Bryan and the Populists. Before he left office the privileged few would wince under the stigma of such epithets as "malefactors of great wealth" and "the wealthy criminal class." In a flamboyant speech at the laying of the cornerstone of the House Office Building in April, Mr. Roosevelt, apropos of nothing at all, referred to the desirability of limiting fortunes by taxation. He followed this speech with a message to Congress in December in which he said there was "every reason" why the national government should impose a graduated income tax with the aim of distributing the burden of supporting the government more equitably. He recognized the difficulty of devising a constitutional income tax, but urged that "every effort" be expended on the project. If this failed, there would ultimately be no alternative but a constitutional amendment.

Cordell Hull, the young Representative from Tennessee who was destined to become Secretary of State in one of the most critical periods in world history, introduced his first income tax bill in Congress in 1907. The following year the Democrats, sensitive to a new direction of the political wind, wrote a plank in their platform in favor of an income tax as part of our revenue system and a constitutional amendment enabling such a tax so that "wealth may bear its proportional share of the burdens of the Federal Government." And the Democrats nominated Mr. Bryan to give substance to their argument.

Mr. Taft, the Republican candidate, was not caught napping. After consulting with President Roosevelt, he came out for a levy on incomes despite the fact that his party platform gave him no authorization. Some of the wind went out of Mr. Bryan's sails. Moreover, Mr. Taft thought a constitutional amendment unnecessary. But tariff reform, rather than the income tax, was the campaign issue and, once safely elected, Mr. Taft's flicker of enthusiasm for the income tax went out. He failed to mention the subject in his inaugural address or in his later message to the special session of Congress he called in March 1909. Mr. Taft was more concerned with making opportunities for American businessmen and bankers to operate freely and profitably abroad. Theodore Roosevelt, for nearly eight years, had wielded a big stick in foreign affairs. Under Mr. Taft imperialistic activity took another name. This was the age of "dollar diplomacy." America was deciding that dollars would influence more people than bullets.

The future of the income tax was darkest just before its dawn. The

tax had its friends in the Sixty-first Congress—men like Cordell Hull, Ollie James and Frederick C. Stevens in the House, and Joseph W. Bailey, Albert B. Cummins, John W. Daniel and William E. Borah in the Senate. But Joe Cannon, Sereno Payne and men of different ideas dominated a muzzled House; Payne was Chairman of the vital Ways and Means Committee. Nelson W. Aldrich, Henry Cabot Lodge, Boies Penrose and Chauncey Depew were the leading figures in a conservative Senate; Aldrich was Chairman of the powerful Finance Committee. His handsome face was set "like flint" against the income tax.

Heated debate recalled the Supreme Court's mandate declaring the tax unconstitutional. Proponents of the tax indecorously pointed out that the last income tax law had been invalidated by a 5 to 4 decision. Without intending "any invidious comparison," Bailey argued that the men who constituted the majority "did not outweigh in brain and character" the men who made up the minority. He was willing to "stand uncovered" in the presence of the Supreme Court, but he was not willing to be "silenced" by its decision. He also thought that some arguments advanced in the first Pollock opinion would be described as "pettifogging" if a lawyer had addressed them to the court.

Opponents replied that passage of an act in brazen defiance of the court would rock the whole social system. The statute as drawn would produce "inequality and injustice"; even worse, they charged that the tax was "inquisitorial" and would make the United States a "nation of liars."

Senator Root created a sensation when he calmly stated that in his opinion the dissenting views of the Supreme Court justices in the 1895 case had with them "the weight of evidence." But he "more than doubted" whether the court would reverse itself if a similar case were brought before it on the same basis. It was not right, Mr. Root said, that the executive and legislative branches of the government should conjointly place on the statute books a law that the Supreme Court had pronounced unconstitutional and void.

In the House the indefatigable Hull could do no more than persuade the minority leader, Champ Clark, to insert a demand for a graduated income tax in his motion to recommit the famous Payne-Aldrich tariff bill. Things were miraculously different in the Senate. Hull passed

material and enthusiasm to Bailey. He and Cummins, a Western Republican, formed an unholy alliance. The resulting combination of Democrats and insurgent Republicans pressed hard for a tax on the income of individuals and corporations, amendments which had been offered by Bailey and Cummins. Cummins frankly recognized that his individual income tax amendment challenged the Supreme Court decision in one particular. The "point of collision" was: Is a tax levied upon income derived from an investment in either real or personal property a direct tax? He considered that question so broad and fundamental that it was "utterly impossible" to frame an income tax law that would not run counter to the opinion expressed by a majority of the members of the court. But, the Senator insisted, "if that opinion is to stand in its full scope and with its full vigor, then the United States must abandon for all time, or until the Constitution be amended, the exercise of a power and authority which has been recognized for a hundred years before the opinion was announced." It was "just as constitutional now" and "precisely as just now" to levy an income tax to support the government of the United States as it was in 1861.

The constitutionally learned Borah strongly supported the tax. He favored it "not for the purpose of putting all the burdens of government upon property or all the burdens of government upon wealth, but that it may bear its just and fair proportion of the burdens of this government."

Although the astute Aldrich maintained that the tax had always been advocated "by Populists or by others who sympathize with them in a desire to redistribute the wealth of the United States by this method," his Fabian tactics could not hold a ruptured line. The summer was hot as usual in Washington; the thermometer hovered around 90. There was no air conditioning in 1909, and tempers exploded with the high temperature. The income tax had achieved respectability. Prudently Aldrich changed arguments. The tax was no longer a socialist means of redistributing wealth; it would tend to destroy the protective tariff system, raise unnecessary revenue and harm laboring men because it would reduce "the protection which the law affords to them in competition with the cheap labor of other countries."

The issue of the income tax was out of hand. A more serious danger threatened. The Republican party was in peril of disruption; the shadow of coming events darkened the political landscape. The time

had come for heroic intervention by a harassed executive. At this critical moment President Taft came to the rescue of his party. He was not against the income tax. He had consulted his Attorney General, Mr. George W. Wickersham, and later the eminent Senator Root, about a corporation income tax. But he was against the disintegration of the party which had made him President.

The scene shifted from the Senate chamber to the cool of the evening in Rock Creek Park where the President rode with Congressional leaders. It is not recorded whether Mr. Taft had studied the works of Ambassador Bryce who once said: "To yield a little may be prudent, for the tree that cannot bend to the blast may be broken." But it is of record that from these rides and several White House dinners and golf games at the Chevy Chase Country Club President Taft emerged with a revolutionary compromise proposal: (1) that Congress propose an amendment to the Constitution giving the Federal Government the power to levy an income tax without apportionment among the states in proportion to population; and (2) that Congress impose a 2-percent excise tax either as a substitute for, or in addition to, the inheritance tax, to be measured by the net income of all corporations except national banks, savings banks and building and loan associations.

Congress could only listen and follow the leader. But face was saved on all sides, since the danger of an income tax was postponed indefinitely while the prestige of the Supreme Court remained unsullied. The second part of the President's proposal, modified into a 1-percent excise tax on corporate profits, passed the Senate, and was accepted in conference by Chairman Payne with a cynical explanation that it got rid of an unconstitutional income tax. It became the law of the land on August 5, 1909. Even then it was charged that the tax would encourage unsound debt financing and force firms to disincorporate.

The Corporation Excise Tax of 1909 was a tax upon the privilege of doing business as a corporation. True, the measure of the tax was the net income of the corporation. In Flint *v.* Stone Tracy Company,[1] decided in 1911, a unanimous Supreme Court decided that such a tax was indirect and could reach not only income from business, but also income from state bonds and income from other property not used directly or actively in the business. Thus did a few words change a tax on income

[1] 220 U. S. 107 (1911).

into a tax on something else measured by income. But, as Dr. Thomas Reed Powell has told us, we must believe in such legerdemain as the gentleman believed in baptism because he had seen it. Mr. Justice Day, who was not on the court in 1895, assured the country that the difference between the 1894 Act and the 1909 Act was "not merely nominal, but rests upon substantial difference between the mere ownership of property and the actual doing of business in a certain way." Evidently the Constitution, in the view of a Supreme Court which included only two of the justices who had sat in 1895—and they dissenters—speaking at a different time, had never forbidden the thing done by the 1894 Act, but only the particular way of doing it selected by the Fifty-third Congress. Many gentlemen of that earlier Congress would have been glad to correct the uncertain possibilities of 1894 by the constitutional certainty of 1911.

Again, the evil day had merely been postponed. The other part of Mr. Taft's compromise—his proposal to amend the Constitution—was put into final form and passed an impatient Senate on July 5, 1909, by a vote of 77 to 0. On July 12 the House voted in its favor 318 to 14, 55 not voting. The joint resolution incorporating the amendment, as passed, read:

> The Congress shall have power to lay and collect taxes on incomes from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

The adoption of the joint resolution, the *New York World* said, "rounded out and completed an alliance between President Taft and Senator Aldrich by which a corporation tax amendment to the tariff bill and a proposal to amend the Constitution were to be jammed through the Senate as a means of defeating straight-out income tax legislation."

The first part of Mr. Taft's compromise plan proved to be more than the harmless gesture it was intended by many to be. Alabama ratified the income tax amendment in 1909. Other states followed rapidly without much opposition until, by the action of the thirty-sixth state, Wyoming, on February 3, 1913—ironically, at the beginning of a Democratic administration—the Sixteenth Amendment became part

of the Constitution. Other states followed with ratification. Only Connecticut, Florida, Rhode Island and Utah rejected the amendment, and two states—Pennsylvania and Virginia—failed to take action.

By 1913 Mr. Choate's communistic march of 1894 had covered 42 out of 48 states. In a little more than a year the schedule of destiny called for World War I. In about four years the United States would enter that war and Congress would confer upon Woodrow Wilson unprecedented powers over the economic system of the country. He would be authorized to requisition supplies for the Army without stint, to fix the prices of commodities, to take over mines, factories, railroads, shipping and communications. A little later "the Senate and the House of Representatives of the United States of America in Congress assembled" would pass a bill imposing a 77-percent tax upon individual incomes over $1,000,000 and an 80-percent tax upon the war profits of corporations.

In 1895 Mr. Choate had boldly prophesied:

> There is protection now or never. If it goes out as the edict of this judicial tribunal that a combination of States, however numerous, however unanimous, can unite against the safeguards provided by the Constitution in imposing a tax which is to be paid by the people in four States or in three States or in two States, but of which the combination is to pay almost no part, while in the spending of it they are to have the whole control, it will be impossible to take any backward step. You cannot hereafter exercise any check if you now say that Congress is untrammelled and uncontrollable.

This prediction was almost right. It was possible to take some "backward" steps. But it was never possible to return to Mr. Choate's favorite century.

Chapter 2

TAX BILLS RACE WITH EVENTS

1913-1917

THE SKIES were prophetically overcast on March 4, 1913. Victor and vanquished rode along Pennsylvania Avenue to the Capitol in a maroon-colored open landau. The people had decided on a house cleaning and were using the Democratic party as a new broom. In a few years the victorious Wilson would be tragically frustrated in his plan for world peace and the vanquished Taft would be established in comfort as Chief Justice of the United States. But this denouement was destined for a later act; World War I was still, like the prosperity of a later day, around the corner.

Big business was worried in 1913; criticism of trusts and monopolies persisted. Mr. Wilson's record as governor of New Jersey was disquieting. His drastic views on curbing trusts, embodied in the famous laws known as "The Seven Sisters," had been responsible for driving many large corporations out of New Jersey. There was no serious depression, but politics was a disturbing element; iconoclasts were at work destroying faith in everything that had long endured. The rising cost of living was a topic of the day. In the new President's ignorance of the spectacular future awaiting him there was the bliss of intended accomplishment.

A short-lived harmony reigned in the party of the victors and would quickly produce a new Federal Reserve Act to overhaul the currency and banking system; a Federal Trade Commission to prevent unfair business practices; the Clayton antitrust law, dubbed by Samuel Gompers the "Magna Charta of Labor"; and Federal Land Banks to lend money to farmers at a low rate of interest. "Financial feudalism died in the United States when Woodrow Wilson took the oath of office," said the *New York World* in describing the economic effect

of Wilson's election. But the paper reversed its judgment in the summer of 1914 when Wilson's administration failed to bring about the economic felicity it had predicted.

Tariff reform was the first order of business in the special session of Congress which followed Mr. Wilson's inauguration. The day had not come when a tax bill stood on its own feet; the timid 1913 income tax measure was only Part Two of a revenue act dealing principally with the tariff. By instruction from the Ways and Means Committee Mr. Hull, the "fountainhead" of income tax information, went to work. He wanted to move slowly in order to get the law adjusted to the economic situation in the simplest way possible; he believed the income tax would then stand a better chance of permanency. He favored a flat rate and collection-at-the-source. On the latter point his views prevailed, but John Nance Garner, of Texas (later Vice-President), and Dorsey W. Shackleford, of Missouri, forced the principle of graduation upon the reluctant conservatives.

The Senate passed the bill after prolonged debate and only after a compromise approved by the President fixed the maximum surtax rate at 6 percent upon individual incomes over $500,000. The vote was partisan except that the two Louisiana Senators deserted their party, and two Progressive Republicans, Poindexter and LaFollette, voted with the Democrats. The new law went into effect on October 3, 1913. It replaced the corporation excise tax with a corporation income tax at a rate the same as the normal tax on individuals, 1 percent upon net income. Like the corporation excise tax, the corporation income tax was regarded as a tax on individual stockholders collected at the source, not as a tax on corporate enterprise as such. The act made this relationship explicit by exempting dividends received from the 1-percent normal tax on individuals, but it did not require the inclusion of the tax collected at the source in the surtax net income of the individual taxpayer. This omission prevented the corporation tax from remaining a withholding tax, and may well have been the genesis of the corporation tax problems of the forties. The 1913 Act was declared constitutional in January 1916 by a unanimous Supreme Court in Brushaber *v.* Union Pacific Railroad Company.[1] In 1914 the tax yielded a little over $70,000,000.

Even before 1917 the influence of World War I reached across the

[1] 240 U. S. 1 (1916).

Atlantic. Imports and customs duties fell. Expenses mounted. At the outbreak of war Congress was obliged to appropriate $3,000,000 to bring home stranded Americans, and $5,000,000 to establish a war-risk insurance bureau. In the spring and summer of 1914 Mexican complications increased military expenses. German submarines strangled foreign commerce, and preparedness became a political issue with Theodore Roosevelt as the spokesman of the big Navy group. By the end of 1915 President Wilson was talking "adequate preparation for mobilization and defense." But, in the manner of later years, public opinion and some Congressmen lagged behind these leaders. The Bryanites called the "preparedness hullabaloo" a "rich man's scare." Mr. Kitchin, of North Carolina, Chairman of the Ways and Means Committee, talked about the "fabulous increase of appropriations." A little later Secretary of the Treasury McAdoo entertained members of the Ways and Means Committee and the Cabinet at "speed-up dinners," with the hope of making some headway on a new revenue program. Mr. Wilson planned tours to carry the issue of preparedness to the people.

In 1915 Congress responded to revenue pressure with an additional emergency tax on fermented liquors, wines and gasoline and some stamp and other special excise taxes. But a deficit of $177,000,000 loomed for June 1916. Still Mr. Wilson trusted mainly to excises; he suggested additional taxes on gasoline, naphtha, automobiles, bank checks and pig iron. But for the first time the administration also suggested changes in the income tax: a reduction in personal exemptions, and a lower starting point for the surtax. Although these suggestions were not accepted, a revenue act was passed September 8, 1916, a few months after the 1913 Act had been declared constitutional. To the amusement of some Republicans it was called a "nonpartisan" measure. Senator LaFollette talked of preventing tax-dodging. Nicholas Longworth, son-in-law of Theodore Roosevelt, succeeded in inserting a provision for the taxation of stock dividends. Over the protests of Justices Holmes, Day, Brandeis and Clarke, Mr. Charles Evans Hughes, the defeated 1916 Presidential candidate, persuaded the Supreme Court on reargument that the taxation of stock dividends was unconstitutional.[1]

The 1916 Act raised the normal tax to 2 percent, and the surtax

[1] Eisner *v.* Macomber, 252 U. S. 189 (1920).

from a maximum rate of 6 percent to a maximum of 13 percent on incomes over $2,000,000. The act took another step in the "radical" direction of discouraging rapidly growing fortunes. Inheritance taxation had been used as an emergency measure in 1867 and 1898. The 1916 Act adopted an estate tax as a permanent feature of the revenue system, with a top rate of 5 percent. A large number of states had also begun to levy progressive taxes on incomes and inheritances. Taxation, even then, was not for revenue only.

Tax bills were in a race with events. Governmental expenditures would produce a deficit of $9,000,000,000 by the end of the fiscal year 1918. But the country was prosperous. The *New York Times* considered the emergency only temporary. Members of Congress, then as now thinking of re-election, were more concerned. Mr. Rainey, of Illinois, ranking Democratic member of the Ways and Means Committee, volunteered an opinion that income tax rates had reached "the very highest notch." The Democratic majority in the House turned to the excess-profits tax partly as an escape from a lowered personal exemption. The German Government intervened with an announcement of relentless submarine warfare. A little later, while the House bill was in the hands of the Senate Finance Committee, threats became reality: two American vessels were sunk by German submarines. Senator Norris, far ahead of his own time or even the present day, suggested flexible income tax rates. Senator LaFollette filibustered. Finally, the Democrats forced the House bill through a reluctant Senate, and on the last day of his first term Mr. Wilson signed the abortive Revenue Act of March 3, 1917. It imposed the first excess-profits tax on corporations and partnerships, and it raised the estate tax rates 50 percent. The act became obsolete on April 7, 1917, when Congress declared war on Germany.

Chapter 3

FINANCING WORLD WAR I

1917-1919

World War I changed both the scale and the pace of financial events. Deficits in millions became deficits in billions. The total appropriations in the calendar year 1917, $19,000,000,000—which included $7,000,000,000 of loans to the Allies of that day—approached the total cost of the Federal Government from 1791 to 1917, $26,000,000,000, including the expense of three foreign wars and one internal war. This one-year cost was three times the cost of the Civil War, which had lasted four years. Wealthy people shuddered, and thought with nostalgia of "top-notch" prewar rates. Taxation could no longer balance the budget; the amount to be borrowed became an issue, with Senator LaFollette constantly a thorn in the flesh of the heavy borrowers.

The pattern of later events was visible in 1917. Foreign war had made the country prosperous. Inflation threatened. Corporate profits were high. The stock market, after a temporary closing, was booming. Taxes were the lump in the porridge, and they would have to be raised still higher because of a loss of revenue from liquor taxes. National prohibition had become law just after the middle of 1917, allegedly as part of a food conservation program.

Congress spent more than five months on the $2,500,000,000 Act of October 3, 1917, the first war revenue act. The debate was principally over excess-profits and individual tax rates. Mr. Hull proposed as a substitute for the excess-profits tax a war-profits tax based upon the English model which would heavily tax earnings over the level of the prewar years. Others favored an excess-profits tax with an exemption based upon invested capital. The final product was a compromise,

which was far from satisfactory to many critics of the times. The basis of the tax was net income from all sources rather than strictly business profits. It applied to corporations, partnerships and individuals and was levied on the difference between prewar average profits and the profits of the war years. It used the average prewar profits during 1911, 1912 and 1913 as the basis for the exemption, but made a substantial concession to the excess-profits principle by placing this exemption at not less than 7 nor more than 9 percent of the invested capital for the taxable year. The rates were graduated from 20 to 60 percent. The act also contained a special "penalty" tax upon undistributed corporate earnings, the grandfather of the 1936 undistributed profits tax.

Against the protests of such Senators as Penrose and Lodge, Congress imposed high additional income taxes. An extra normal tax of 2 percent was levied upon individuals, making the total normal tax 4 percent, and an additional surtax with brackets ranging up to 50 percent, making a total surtax of 63 percent and a combined normal tax and surtax of 67 percent in the highest brackets. Normal tax exemptions were dropped from $4,000 to $2,000 for married persons and from $3,000 to $1,000 for single persons. The surtax exemption was dropped from $2,000 to $500. For the first time a dependency credit of $200 was allowed. Mr. Choate's bad dream of 1895 had indeed come true.

Collection-at-the-source was scuttled with little opposition. Mr. Hull's victory in 1913 was short-lived; the first attempt at pay-as-you-go had been castigated as an administrative headache. Repeal had been agitated in the Emergency Revenue Act of 1914 and again in the Revenue Act of 1916. The War Revenue Act of 1917 saw its unwept demise. A quarter of a century would pass before vindication would come to a man who would then be laboring in other vineyards.

The 1917 Act was the only revenue measure enacted during the war, and its shortcomings were soon apparent. For the fiscal year ending June 30, 1918, with $3,400,000,000 of tax revenue the Treasury anticipated an unplanned-for deficit of more than $6,000,000,000 and for the fiscal year 1919 a further deficit of $1,000,000,000. Early in May 1918 the *New York World* quoted Mr. McAdoo as saying that a new bill raising $6,000,000,000 or $7,000,000,000 should be passed before Congress adjourned. Such leaders as Kitchin, Simmons, Garner, Fordney, Lodge and Smoot all opposed a tax bill. The session would

soon be over and elections were coming in November. The legislative impasse was almost complete.

On May 27 Mr. Wilson, still called the "college professor," addressed both Houses of Congress in a high-minded speech which the *New York Times* said "warmed the hearts of true Americans." His request for a tax bill was solemnized by news, just as he left for Capitol Hill, that the expected drive on the Western Front had begun. He said:

> Our financial program must no more be left in doubt or suffered to lag than our ordnance program or our ship program or our munitions program or our program for making millions of men ready. These others are not programs, indeed, but mere plans upon paper, unless there is to be an unquestionable supply of money. . . . Politics is adjourned.

But politics was not adjourned. The ending of the war in November found the delayed 1918 Act in the hands of the Senate Finance Committee. A Pennsylvania Republican emphasized the heavy taxation of the steel industry and the exemption of cotton and corn. A Democratic Senator gave a pathetic account of the poverty of the cotton-growing South. Another Democratic Senator thought that the $8,000,000,000 bill passed by the House would "cripple industry." Senator Lodge agreed. Such a bill might well "tend to reduce profits to a point which will dry up the sources of the income tax," and so deplete funds that Liberty Bonds could not be sold. Later the United States Chamber of Commerce protested that the proposed rates were so high that they would injure business and restrict expansion at a time when the resources of the country should be used to permit the employment of men returning from the war.

The Republicans won a decisive victory in the 1918 election, gaining a majority in both Houses of Congress. This success changed sectional politics into party politics. Hungry for more power, the Republicans looked forward to greater success in 1920. Their previous demand for a low tax bill changed overnight to a demand for a high tax bill. Senator Borah could not "understand" the "mystery." But reasons were plain enough. A high tax would be the political burden of the administration in power and would leave ample funds in the Federal Treasury when the minority party became the majority party. The deadlock was almost complete. There might have been no 1918 Act if business had

not intervened. The bill must be written, business thought, so that tax obligations would be known. Then, as now, business writhed under uncertainty.

The bill was written, or rewritten, but it did not become law until February 24, 1919. It was, of course, really a war revenue act which applied retroactively to a war year. In its final form it imposed a low income tax on corporations (12 percent for 1918 and 10 percent for subsequent years) and excess-profits and war-profits taxes with rates reaching 80 percent. The individual normal tax was raised to 12 percent for 1918 income, and 8 percent for 1919 income, above $4,000; the surtax began at $5,000 and reached a top bracket of 65 percent.

The act contained several relief provisions which increased its complexity and its length to 106 pages. In the House Cordell Hull had declared that "equity and simplicity should be the prime requisites of any law." Dr. T. S. Adams, the Treasury expert, said:

> There is an imperative need for immediate simplification in the system of internal revenue taxes. The unvarnished truth is that the income and profits taxes are so heavy and so intricate that a sufficient number of auditors and experts cannot be secured by the Government to audit, assess, and settle old claims as fast as new claims are created.

Somehow the administrative job was done. But twenty-five years later we were to hear strikingly similar pleas for simplification with just as little examination into the philosophy of the subject.

Chapter 4

HIGHER INCOMES AND LOWER TAXES

1921-1928

THE SPELL of the war to end war was soon broken. The moral strain of making an entire world safe for democracy told on the American people. Mr. Wilson was stricken in the fall of 1919, while fighting for his lost cause, the League of Nations. James M. Cox, the Democratic candidate for President in 1920, was helpless against the double talk of his adversaries and a new public apathy. The people wanted no more crusades; they were war-weary and talk-weary. Production was falling. Almost every day the high cost of living was making the headlines. The Republicans declared that the country needed tax revision "to lower the cost of living, restore business confidence, and stimulate enterprise." These cliché phrases became the slogans of a new crusade for normalcy.

The handsome, amiable Mr. Harding led the people in this nostalgic quest. As if to symbolize their weariness, he campaigned from his front porch in a small Ohio town. He could not endure the thought that Mr. Debs should languish in prison for violation of the sedition laws, but he could strike grimly at war taxation. War taxation blocked a return to the good old times Mr. Harding loved, when a high tariff policy filled the coffers of the Treasury, safeguarded American industry, stimulated development and made the American record "a matchless one in the story of the world."

But the masters of business had not fared so badly during the war years. Between 1914 and 1919 the number of persons reporting taxable incomes of from $10,000 to $40,000 a year rose from 120,000 to nearly 192,000 and the number reporting between $40,000 and $100,000 a year mounted from 8,300 to almost 22,000. Conservative estimates

indicate that there were more than 42,000 millionaires in America at the close of the war for democracy.

The collectivist principle embodied in income, inheritance and excess-profits taxes was not to Mr. Harding's conservative taste. A radical modification of Mr. Wilson's harsh tax program was in the cards. The prophet of normalcy believed that no tax statute or, for that matter, any other statute enacted by man, could "repeal the inexorable laws of nature."

The excess-profits tax was, no doubt, the chief offense against the laws of nature. It retained few friends. Some businessmen contended then, as some businessmen would contend a quarter of a century later, that the tax was shifted to consumers, which was hardly a valid argument from a group that favored a sales tax. In 1919 Secretary of the Treasury Glass had said that the tax encouraged wasteful expenditure; put a premium on overcapitalization and a penalty on brains, energy and enterprise; discouraged new ventures and confirmed old ventures in their monopolies. The National Association of Credit Men talked of the inequities of the tax and the National Association of Manufacturers maintained that it disregarded "the essential relation between the risk of an enterprise and its return, a consideration which lies at the very foundation of all business investment and operation." In 1921 Secretary of the Treasury Houston thought the desire to abolish the tax might be nothing more than a desire to substitute a tax on consumption goods which would be paid by the masses, but he was willing to see the tax repealed because of its inequitable burdens and administrative difficulties.

The law was so fraught with complications that its administration was in danger of collapse. An enormous number of returns for the calendar years, 1917, 1918 and 1919, were yet to be audited by a Bureau of Internal Revenue inadequately staffed and subject to constant turnover of personnel. Then, as now, a steady stream of employees with valuable training and experience flowed out to more lucrative jobs in private business. In the nine months between October 1, 1919, and June 30, 1920, nearly 1,000 employees left the service. In failing to make public positions attractive to able men by providing adequate salaries, prestige and security, American government was demonstrating one of its fundamental weaknesses.

Dr. Adams had always been worried about these difficulties; he said

he would thank God if the Bureau of Internal Revenue, with the favor of the Almighty and all the ability and talent it could possibly procure, "gets through the next two or three years." This was the plea that prevailed over the arguments of Professor David Friday, of the University of Michigan, who defended the tax on the score of justice and its beneficial economic and industrial effects, and Dr. Robert M. Haig, of Columbia University, who thought the tax helped to eliminate monopoly profits and enabled the American public to seize "some of the promised advantages of socialized industry without incurring the risks and disadvantages of socialism." Practically the only other defenders of the tax were found in the newly formed farm bloc.

Party leaders joined the new President on his march back to a century that was gone. Mr. Fordney was Chairman of the Ways and Means Committee, Mr. Penrose of the Senate Finance Committee. Senators Smoot, Warren, Watson and Lodge led the procession. The rich Mr. Mellon made the Treasury safe for tax reduction. Only a few Western voices protested.

Mr. Mellon did not waste time as he thought Congress had been wasting money. He told Mr. Fordney a story of a "shocking rate" of expenditures. He was ready with five tax suggestions. He would substitute a modified tax on corporate profits, or a flat additional income tax on corporations, for the excess-profits tax. He would cut income tax rates so that the maximum normal tax and surtax rates would be 40 percent for 1921 and 33 percent thereafter. He would keep the miscellaneous sales and excise taxes, and impose such new taxes of wide application as stamp taxes or license taxes on automobiles. Finally, he recommended administrative amendments to simplify the work of the Bureau of Internal Revenue. Later, before the Senate Finance Committee, he altered his recommendations in one respect; he urged that surtax rates be reduced to a maximum of 25 percent after 1921.

Congress gave Mr. Mellon only part of a loaf. The Revenue Act of 1921 repealed the excess-profits tax, raised the corporation tax from 10 percent to 12½ percent, retained most of the special excises and stamp taxes, and established a Tax Simplification Board to suggest improvements in the law and its administration. The maximum surtax rates were reduced, but the hole in the loaf was that the reduction was only from 65 percent to 50 percent.

Mr. Mellon's favorite proposal was the reduction of surtaxes, espe-

cially in the upper brackets. Throughout his term of office he consistently opposed high surtaxes and the "obnoxious" Federal estate and gift taxes. He used every means at his command to have the estate and gift taxes repealed and in 1926 found an apathetic Congress ready to meet him halfway. The gift tax went into the discard. But his efforts to dispose of the estate tax, although reinforced by pressure from powerful organized groups, were not crowned with equal success. Chairman William R. Green, of the Ways and Means Committee, and Mr. Garner played important roles in saving the estate tax from the Secretary's destroying touch. Mr. Mellon, however, was not to be foiled and his persistence carried beyond the grave. Unable to erase the estate tax from the books, he left his art treasures and millions to a National Gallery, bringing joy to art lovers and tax exemption to his estate.

Mr. Harding's death in August 1923 may be some proof that it takes more than an average American to be President. Worry over the scandals in his administration undoubtedly hastened his end. For a moment a small town in the granite of the Vermont hills captured national attention, while the father of a man of iron administered the Presidential oath to his silent, austere son. The ceremony had a purifying effect; the corruption of the genial Mr. Harding's administration was washed whiter than New England snows. But throughout Mr. Coolidge's short term and his elected term other sins remained scarlet. Youth continued to flame. Prohibition was demoralizing government to the core. The holding company technique made fortunes for capital that lowered taxes allowed to venture into new financial territories. The religious center of gravity had shifted. Mr. Coolidge, on guard at the White House, believed in thrift and industry; "the man who builds a factory builds a temple."

It is not strange that Mr. Coolidge kept Mr. Mellon as Secretary of the Treasury. Their tax philosophies were in accord. The President stood fast by normalcy and economy; in fact it was said that he gave the most practical demonstration of economy ever seen in our government. His program was simple: tax reduction in the upper brackets. He thought the prosperity of the middle and lower classes depended upon the good fortunes and light taxes of the rich. He was against using income and inheritance taxes to shift part of the burden of taxation from the poor to the rich. "If we are to adopt socialism," he said,

"it should be presented to the people of this country as socialism and not under the guise of a law to collect revenue."

Mr. Mellon continued his fight against high rates, with the additional argument that they were only a war measure and were unproductive in time of peace. The new Congress which came in with Mr. Coolidge's elected term saw the light and rates went down. Good times grew even better. In the single year 1925, the income of private persons from rent, interest and dividends, reported for tax purposes, rose from $6,776,000,000 to $7,435,000,000. The nation had entered the "era of wonderful nonsense."

Chapter 5

THE ECONOMY HITS BOTTOM

1928-1932

WITH PERHAPS uncanny prescience Mr. Coolidge did not choose to run in 1928. The skies were never brighter. Stock market values were soaring; goods were selling; investment trusts were booming; and foreign loans were yielding high commissions. True, there were signs of distress and discontent. Farmers and planters were doing badly. Intellectuals and radicals could not forget the execution of Sacco and Vanzetti and the unfortunate Mooney affair. But the President and Mr. Mellon officially assured the country that its fundamental economic basis was "sound."

There could have been no better guardian for the glamorous Coolidge prosperity than his popular Secretary of Commerce, Mr. Hoover. He was a rare combination of great engineer, efficient executive, rugged individualist and tender humanitarian. In 1923 he had urged insurance companies to add unemployment to the list of casualties against which they provided indemnity. He had endorsed a constitutional amendment to abolish child labor. He was on record in favor of an inheritance tax to "redistribute overswollen fortunes." As soon as he was nominated he spoke, with less prescience than his predecessor, of the abolition of poverty. He thought we were nearer than ever in our history to the final triumph over poverty, and that, given a chance to go forward with the policies of the last eight years, "we shall soon, with the help of God, be in sight of the day when poverty shall be banished from this nation. There is no guaranty against poverty equal to a job for every man. That is the primary purpose of the policies we advocate." Mr. Hoover proved that such arguments win an overwhelming vote, even against a candidate who attacked the noble experiment, prohibition. But he proved to be less than an accurate prophet,

and he later demonstrated that he did not understand the calamity that had descended upon the world.

The first evidence of that calamity came when the boom reached its climax in August 1929. In September and October stock values, which had risen steadily for two years and which Professor Irving Fisher of Yale declared had reached "a permanently high plateau," fell 40 percent within six weeks. Despite statements by President Hoover, Treasury officials, bankers and other financial leaders that the market decline was not due to any basic business weakness, by November $30,000,000,000 of capital values had been lost. In defiance of the ancient Wall Street precept that "what goes up must sooner or later come down," on October 30 Mr. John D. Rockefeller, Sr., issued a statement saying that "my son and I have been purchasing sound common stocks" and would continue their purchases. That day the Dow-Jones Industrial Averages stood at 258.47; by July 8, 1932, they had declined to 41.22. The piper was insisting upon payment for the wild dance of advancing and inflated prices. Deflation was beginning a long session with a nation which would become all too familiar with the poverty Mr. Hoover had promised would be banished from the land.

The Revenue Act of 1932 was the last of five Republican tax bills. Conditions were deplorably different from the happy days of the twenties. The golden glow had faded; the national gloom had deepened; the dismal decade dragged along. Estimates of revenue kept going bad. The Treasury, still in the hands of the President's old Cabinet colleague, Mr. Mellon, had ceased to bulge with surpluses; a deficit had to be financed. The House was Democratic; Speaker Garner promised Senator Watson, however, that there would be no politics. But this was small cheer in the face of the desperate economic conditions which confronted the country. Banks were failing right and left. Sullen men and women lived wretchedly in Hoovervilles. The mortgages of better days were too high for Western farms. Veterans of the World War were insurgent on a national scale. A bonus army—ghostly reminder of Coxey's famous army—had marched on Washington only to be dispersed with tear gas and bullets. General Douglas MacArthur, the Army's chief of staff who in World War II was to become the hero of Bataan, the liberator of the Philippines and commander of the occupation forces in Japan, took personal command of the evacuation operations. But the problems of the nation could not

be solved by mobs in Washington. Mr. Hoover's elusive prosperity was keeping stubbornly around the corner of a street that was dark with dread.

The "greatest Secretary of the Treasury since Alexander Hamilton" counseled the people to wait patiently and all would be well: "The markets will absorb present surpluses, then the business depression will better itself, and the price mechanisms will be set aright." Of course, Mr. Mellon could wait patiently, but people waiting in bitter lines for bread and soup were less philosophical. They wanted a leader who would bring a better day, not merely one who believed in passive waiting. Laissez-faire economics was cold doctrine when wives and children were starving and work could not be found.

Mr. Mellon had had no experience qualifying him to deal with deficits. On January 25, 1932, Under Secretary of the Treasury Mills read his superior's statement to the Ways and Means Committee. The Secretary's never robust imagination produced no new remedies. The budget must be balanced; the public debt must not increase; unnecessary expenditures should be curtailed; every available resource should be tapped for increased revenue. This would involve self-denial; yes, even "some measure of sacrifice." Mr. Mellon was not explicit about who should do the sacrificing, but his good friend, Senator Reed of Pennsylvania, had previously suggested a sales tax. Mr. Mellon, less courageously, merely doubted the efficacy of the income tax which he had recently discovered was subject to great fluctuations in business conditions. In times of depression, he said, large incomes fell a greater percentage than smaller incomes. He recommended some increase in both the surtax and the normal tax rates, but he also wanted the law revised so that many more people would pay income taxes than previously.

This started the most furious sales tax controversy Congress has ever witnessed. The Ways and Means Committee finally voted a manufacturers' excise tax on the Canadian model which the Secretary had opposed because it would be difficult to administer and would add to the cost of living. Argument in the House was bitter, with LaGuardia, Garner and others in revolt. Representative Lozier, of Missouri, with more eloquence than Biblical accuracy, saw the adroit hand of Ogden "Esau" Mills putting over "the most far-reaching political three-shell game since Esau deceived the half-blind Jacob." The picturesque

Rainey, with his tousled white hair and flowing Windsor tie, defended the committee bill. The gallant Doughton, spearhead of the opposition, broadcast an address against the tax. The bill was finally submerged in a deluge of amendments exempting specific commodities, such as harness; crates; baskets; boxes used for handling, packing and shipping fruit and vegetables; turpentine or resin; ice; artificial limbs; coal; fuel used in the home; and the American flag.

The battle was renewed in the Senate. In the midst of the Finance Committee deliberations came a message from the White House aimed at the dilly-dallying of the committee and the rejection by the House of the Ways and Means Committee bill. The most essential factor to economic recovery was the restoration of confidence; this, the President argued, was impossible when vast appropriations destroyed the possibility of economy and a balanced budget. The situation "inexorably" necessitated a broader basis of taxation. Arthur Krock of the *New York Times* thought the message a "bull's eye," but Senator Reed had to step forward to defend the administration against Congressional criticism. He won no good will by his remark that what the country needed was a Mussolini. The President spoke again on May 31 in favor of a general manufacturers' excise tax with exemptions of food and clothing, explaining that such a tax was not to be confused with a sales tax which could be pyramided. The Senate was inattentive and passed the bill on the same day, with no manufacturers' excise tax or sales tax. The act increased income tax rates, almost doubled estate tax rates, and restored the gift tax. Mr. Mellon had become Ambassador to the Court of St. James's before this sweeping defeat of his cherished policies.

The American economic machinery was completely stalled. In the year 1932 national income had dropped to $40,000,000,000, almost to the level of 1913. Foreign countries had withdrawn nearly $500,000,000 from the United States in gold. Alarmed citizens were hoarding currency in mattresses, bureau drawers and sugar bowls. Credit for the conduct of business had begun to dry up. Tax revenues had fallen off by nearly one-half.

Nineteen hundred thirty-two was no ordinary campaign year. The country was passing through one of the greatest trials in its history. The voters were bowed down under the strain of their individual and collective worries; large numbers appeared to be almost on the verge

of political hysteria. Once more the tariff was a campaign issue. The Democrats said the "bubble burst first" in the United States and the major collapse abroad followed. They blamed the disaster on the boom inflation and stock prices and the "notorious and indefensible" Smoot-Hawley Tariff Act of 1930 which imposed high to prohibitive tariffs on practically everything dutiable this country imported. Mr. Roosevelt, the Democratic candidate, called the act a "ghastly jest." The Republicans claimed that a major part of the shocks and dislocations which had brought on this destruction was of foreign origin—not of American making. They pointed out, and found some comfort in repeating, that things could have been worse. Mr. Hoover predicted grass in the streets if the Democratic proposals to reduce the tariff were accepted.

Little grass was perceptible, but apple sellers blocked the sidewalks of New York. Already the country had known what it meant to have hogs drop to 4 cents, wheat to 30 cents, corn to 12 cents and cotton to 5 cents. People were selling stocks for 50 cents a share for which they had eagerly paid $25 a share in 1929. The depression had jolted the easy optimism of the twenties. Some economists prescribed a simple cure-all: lower tariffs, renewed lending abroad and cancellation of debts and reparations. Others were less dogmatic and stood on the classic doctrine of laissez-faire: Let us alone and rely upon the automatic functioning of the market. "Pump-priming" had not yet been suggested as a panacea.

In May of 1931 the Oesterreichische Creditanstalt, Austria's largest bank, had collapsed. Foreign bankers withdrew their short-term loans and the crisis spread to Germany. Europe was threatened with a sudden standstill of even the most indispensable economic functions; only a miracle could save it. The miracle seemed to come from America. On June 20 President Hoover proposed a one-year moratorium on the payment of intergovernmental debts, as a move toward world economic and financial rehabilitation. On July 6 he announced the acceptance of his moratorium by all the important creditor nations. But for the German banks the miracle came too late. On July 13 the Darmstadter und Nationalbank, one of Germany's largest, stopped payments. In September Great Britain abandoned the gold standard and became the first great nation to use monetary depreciation as a weapon of recovery. In rapid succession forty nations followed suit.

The handwriting on the wall spelled out an ominous message. The moratorium had only stayed the evil day.

The American scene was remarkable in one respect. In other panics leaders in government and industry had assumed that the government was powerless to ward off periodical depressions. But this time different opinions were heard. Even before the financial crisis of 1929 the Hoover plan for expansion of national, state and local public works in anticipation of a slump had been presented to the governors of the 48 states. Now still more schemes blossomed. Every economist, financier and bloc leader had a nostrum. George Soule, Stuart Chase, Adelbert Ames, Gerard Swope and the United States Chamber of Commerce came forward with programs. Significantly, most of these plans agreed on one proposition, which nevertheless would be debated for more than a decade. This proposition was that the primary cause of disastrous unemployment is the inefficient distribution of wealth which diverts too much income to groups that tend to save a large part of their income and leaves too little to those who must spend all of their income on consumption goods.

On February 14, 1933, Governor Comstock, of Michigan, startled the country by declaring an eight-day moratorium for the state's 550 financial institutions. Twelve years of reducing taxes, budget balancing and rigid economy had been tried and found wanting. The house of cards was collapsing. Fear stalked the land. Revolution, not prosperity, was around the corner.

Chapter 6

FISCAL POLICY IN A GREAT DEPRESSION

1933-1935

THE AMERICAN people had decided in November 1932 to change leaders. The great engineer had preached the abolition of poverty, but in his administration the American standard of living had fallen to a disastrous level. For the last time in American history the government remained for four months in charge of a lame-duck administration. The defeated and newly elected Presidents failed at a temporary coalition. March came none too soon. Plants and businesses were lying idle; 12,000,000 men and women were unemployed. Towns and cities were filled with young men crying: "Give us work! Give us work!" Relief demands had passed all experience and were not being met anywhere. U. S. Steel for the first time cut its preferred stock dividend. A fashionable New York department store was selling $150 necklaces for $22.50. By the afternoon of March 3 scarcely a bank in the country was open for business. Proclamations temporarily closing them had been issued by the governors of almost all the states.

Mr. Hoover and Mr. Mills made a last plea for a balanced budget. Borrowing, they thought, would have disastrous consequences; it would tend to lower the price of government securities; this in turn would disturb the solvency of banks and depress private bonds. Expenses must be cut to the bone. On the revenue side a sales tax was the only solution they could suggest. In January 1933 the Secretary of the Treasury broadcast a promise that the President would bear down upon Congress for revenue legislation. But Congress proved inattentive to a defeated President. The Ways and Means Committee was engaged in its favorite indoor sport of tariff-making. The Senate,

waiting for a new administration, dialogued and jangled along over appropriation bills. The good-humored Barkley was mildly cynical: "No good is coming out of this session anyway between now and the fourth of March," he said, adding that talking might be the least harmful thing the Senate could do.

On March 4, 1933, new words of hope came from the lips of a man who could not then know that he faced more than twelve years of the hardest job in the world. A contagious smile replaced a lugubrious frown. "The only thing we have to fear is fear itself." The speaker was a veteran victor; though a wheel chair would become White House equipment, his indomitable spirit had conquered a dreaded physical disease. He had no sooner taken the oath of office than he made a swift series of brilliant, if somewhat chaotic, moves which made his first "hundred days" historic, and promised to put an end to the "continuing descent into economic hell" of the past four years. He immediately proclaimed a "bank holiday" extending from Monday, March 6, through Thursday, March 9, "in order to prevent the export, hoarding or earmarking of gold or silver coin, or bullion or currency, or speculation in foreign exchange." The gold standard was abandoned.

President Roosevelt had preached economy in his campaign, and set out to practice it. But events were stronger than intentions. The emergency was acute. Farmers and manufacturers were staggering under surpluses which could not be sold. Mountains of goods had piled up in warehouses. In May Congress passed the Agricultural Adjustment Act which tried to solve the eternal farm problem by curtailing crop production and giving subsidies to farmers for reducing the amount they produced. In June the new President signed the National Industrial Recovery Act, which authorized billions for public works and was designed to stimulate business and create new purchasing power for workers. The Home Owners' Loan Corporation was established to aid people in peril of losing their homes under mortgage foreclosures. It was decided to postpone general tax revision and concentrate on banking and recovery measures. The NIRA made a few tax changes, the chief of which were a tightening of the loss provisions, a new type of capital stock excess-profits tax on corporations, and a dividend tax to be collected at the source.

The Revenue Act of 1934 was the first comprehensive revenue meas-

ure of the New Deal. In January of that year the President had outlined his plans for spending for relief and recovery. This meant a budget of almost $10,000,000,000 for 1934 and a deficit of over $7,000,000,000. The theory of the act, as explained by Chairman Doughton of the Ways and Means Committee, was to increase revenue by preventing avoidance rather than by raising rates. The committee had been guided by the basic tax canons of equity, consistency and certainty.

Studies of tax avoidance undertaken by the Ways and Means subcommittee on tax revision had been made public in December 1933. With some of the subcommittee's recommendations the Treasury disagreed. It opposed extending the personal income tax exemption to the surtax, arbitrarily reducing deductions for depreciation and depletion, abolishing the privilege of filing consolidated returns and disallowing deductions for certain partnership losses. It favored more liberal treatment of taxes paid to foreign governments.

The final product of Congress was a compromise. The Revenue Act of 1934 provided for one normal tax instead of two, as had been the practice for a number of years, and a higher surtax schedule representing an adjustment partly to offset the effect of the decrease in the normal tax rate and partly to increase the burden in the middle brackets. The earned income credit, which had been repealed in 1932, was restored. Marital exemptions and dependent credits were for the first time allowed for surtax purposes. A new method was introduced for taxing individuals' capital gains and losses which gauged the tax to the period of holding the asset sold. A number of restrictions were placed on deductions. Railroads alone were allowed to file consolidated returns, and an additional tax of 2 percent was charged for the privilege. The corporate reorganization provisions were tightened and clarifying provisions were inserted to prevent tax avoidance by partners. A surtax was imposed on undistributed earnings of personal holding companies. Estate and gift taxes were raised. The tax on soft drinks was repealed; some other excises were retained at the same rate or increased. The capital stock tax and declared-value excess-profits tax, due to expire in July when the Prohibition Amendment was repealed, were re-enacted.

The 1933 honeymoon could not last. Economic conditions improved, but recovery was slow. Many remained unemployed. Radical doctrines found louder voices. New winds disturbed grass roots. In

California, the elderly Dr. Townsend found millions of disciples for his gospel of salvation—an old-age pension plan, which provided $200 a month to each unemployed person over sixty on condition that the money be spent in the United States within thirty days. In the South the raucous activities of Huey Long dramatized the aspirations of millions for economic equality with his "Share-Our-Wealth-Club: Every Man a King." He promised his followers a "guaranteed" income of $2,500 a year. The Democrats had an attack of nerves. Indications were plentiful that the Louisiana Kingfish would accomplish the defeat of Joe Robinson and Pat Harrison, two of the party's Senate stalwarts, and that he might become master of the entire Lower Mississippi Valley and parts of the West as well. In the North Father Coughlin, a Roman Catholic priest with a small parish near Detroit, knit many together in his National League for Social Justice. Over the radio he inveighed against bankers, communism and capitalism. His platform included such demagogic planks as: "A living annual wage," "Control of private property for the common good," "Social taxation" and "Simplification of government." The Western Farmer-Laborites were becoming restive. Congressional debates on the social security bill in 1935 indicated strong left-wing opposition to the President. The right-wing owners of wealth had another opinion about sharing wealth. The emergency was over; the President's usefulness had diminished. He was listening to dangerous counselors who urged the political necessity of a tack to the left.

In the spring of 1935 Mr. Roosevelt was dealt a major blow. On May 27 the New Deal's "Blue Eagle" toppled under the onslaught of a New York chicken dealer, when the Supreme Court handed down a decision invalidating the code-making provisions of the National Industrial Recovery Act.[1] The NIRA was one of the key measures of the recovery program. Its codes of fair trade practices were designed to arrest the deflationary pressures of the depression years. A question of executive authority was at issue. Chief Justice Hughes, speaking for a unanimous court, held that Congress could not delegate legislative power to the President to exercise "virtually unfettered" discretion to make whatever laws he thought necessary for the rehabilitation of industry. Even Mr. Justice Cardozo, concurring, objected to delegation which was "running riot." The statute and the code-making

[1] Schechter Corporation *v.* United States, 295 U. S. 495 (1935).

powers under it were not a valid exercise of the power of Congress to regulate interstate commerce.

Washington was agog over a decision which cast a long shadow of doubt over the current governmental direction of the nation's economic life. Donald Richberg, Chairman of the National Industrial Recovery Board, and Solicitor General Reed, who had argued the case for the government, were downcast. Senator Borah welcomed the decision. Senator King "thanked God for the Supreme Court." The Republicans were pleased over the vindication of Mr. Hoover's recent attacks on the recovery techniques of the New Deal. The case of the Manhattan chickens promised to take rank with the Pollock decision.

Four days later the President met the press. His bitterness was apparent. The Supreme Court, he said, had deprived the government of all control over economic and social conditions by interpreting the Constitution in the light of the "horse-and-buggy days" of 1787, when it was written. The first shot in the battle which was to be fought out on the field of the 1936 elections had been fired.

In his annual Budget Message of January 1935 Mr. Roosevelt had stated that no new taxes would be needed. This statement, and the lull that followed, served to dramatize his unexpected message of June 19, 1935. The message quoted Andrew Carnegie's testimony in favor of mass co-operation in the accumulation of wealth: "Where wealth accrues honorably, the people are always silent partners." Mr. Roosevelt also quoted Theodore Roosevelt to underscore his point that vast inheritances "bless neither those who bequeath nor those who receive." The President recommended an inheritance tax in addition to the estate tax, gift taxes suited to prevent evasion of the inheritance tax, increased income taxes "upon very great individual incomes," and a corporation income tax graduated according to the size of corporations with an intercorporate dividend tax to prevent evasion.

Congressional leaders were stunned. Mr. Roosevelt was out of town and no one knew whether he intended to insist upon a bill in that session. The wish was father to the guess that he had no such intention. Hot weather had come. Congress, according to Republican Senator Hastings, was "tired, sick, and sore, and in confusion." He thought the President was merely making "a political gesture intended to offset the great public alarm and the very great interest in the share-the-wealth movement which is so evident" in the country. But hope of

early adjournment finally died and a drive to override most of the President's tax recommendations gathered momentum in the House. Businessmen wailed that the President must be carrying on a private feud with his old friends of Groton and Harvard. Some of the lesser Brain Trusters talked of the need to clip business' wings. A non-committal Secretary of the Treasury appeared before irritable committees. The final result, a "legislative absurdity" according to minority members to satisfy the "whim" of the President, was slightly increased graduated taxes upon larger corporations, increased individual surtax rates—59 to 75 percent—in the top brackets, and increased estate and gift taxes. The act also placed a tax upon intercorporate dividends.

Chapter 7

SOCIAL SECURITY: UMBRELLA FOR A RAINY DAY

1935-1939

In the booming forties it is hard to realize the magnitude of the unemployment problem of the thirties. According to information submitted to the Supreme Court, in the period from 1930 to 1936 the number of involuntarily unemployed at times reached the staggering peak of 16,000,000 persons; frequently it reached 10,000,000. Formidable as these figures are, they were only a partial roll of the destitute and needy. Disaster to the breadwinner meant disaster to dependents. The proportion of unemployed to employable was as high as 30 percent. This meant that about one-third of the people in America were without appreciable income. Effects in human terms of anxiety and hunger and ill health and want cannot be estimated, but the statistics tell a grim story. From 1930 to 1934 over 13,000,000 depositors withdrew $7,000,000,000 from savings banks and closed their accounts. In 1932 and 1933 nearly 11,500,000 industrial insurance policies with a face value of $2,400,000,000 were surrendered, and 32,500,000 policies were allowed to lapse. By June of 1933 city dwellers were losing their homes at the rate of 1,000 a day.

Unemployment had become a concomitant of good times as well as bad. In the prosperous twenties the industrial unemployed fluctuated between 1,400,000 and 4,000,000; the number reached over 1,800,000 in 1929. Harry Hopkins stated in 1937 that 4,000,000 to 5,000,000 unemployed would be a reasonable estimate for future prosperous periods.

Such a loss of productive capacity involved more than the personal misfortunes of workers and their families. It permeated the entire

social structure. Apart from poverty or a less extreme impairment of the savings which afford the chief protection of the working class against old age and illness, it reduced living standards, discouraged marriage and offspring, increased illegitimate births and augmented criminality. It resulted in injury to the health of the unemployed and their families and malnutrition of their children. In the more austere terms of economics it reduced purchasing power. The response was curtailed production and more unemployment, and the vicious downward spiral was on its way.

The problem was beyond private charity, which did its best. It was beyond the capacity of unco-ordinated state activity. Some of the states could not finance relief. If a state was in a position to finance relief by taxes on its industry, it injured its competitive position in national markets and discouraged the establishment of new industries. The "freedom" of a state to contribute its fair share to the solution of a national problem was "paralyzed by fear."

The depression focused attention upon another problem of modern civilization. The structure of the population was changing with a growing proportion of people in the older groups. In 1900 only 4 percent of the population was in the age group of sixty-five and over. The percentage had increased to 5.4 percent in 1930, and included over 6,500,000 persons. An expert projection of vital statistics indicated that by 1980 this same age group might become 14 to 16 percent of the total population, or about three times the percentage of 1930.

While the span of life in which a worker could be a consumer and spender had thus lengthened, the span in which he could be a producer and wage earner had materially shrunk. Urbanization of the population and industrialization of the country were making it impossible for the aged to grow old with grace and dignity by slowing the pace of their work or by performing lighter chores on the farm. And more and more of this advanced age group were helpless economically. They could not earn. Younger men and women were preferred. In times of retrenchment the older were the first to go; even if they were retained, their wages were likely to be cut. Almost one-third of 224 factories investigated in 1930 had fixed maximum age limits for new employees. In four plants the limit was under forty; in forty-one it was under forty-six. In the other plants few were hired if they were over fifty.

Nor had this age group savings to finance old age. One-fifth of the aged in the United States were receiving old-age assistance, emergency relief, institutional care, employment under works programs or some other form of aid from public or private funds. Two-fifths to one-half were dependent upon friends and relatives. One-eighth had some income from earnings, and possibly one-sixth had some savings or property. Approximately three out of four persons sixty-five or over were dependent, wholly or partially, upon others for support.

Industrial pension systems and group retirement plans set up in particular industries left this vast problem virtually untouched. It was difficult to finance state old-age benefits because of migration of population; furthermore, beneficent systems in particular states might attract a movement of the aged to those states. The percentage of old people varied among states. It was obvious that a system of old-age insurance based upon contributions could be operated only by the Federal Government which would have jurisdiction to collect contributions in whatever state the worker was employed.

The worker who escaped unemployment in his youth and prudently saved was hardly any better off than the spendthrift. The sturdy virtues of self-reliance and frugality were no bulwark against cycles of depression. In bad times bank accounts must be used for current living; loans on insurance policies must be secured or the policies allowed to lapse; equities in homes proved illusory protection. Mr. Justice Jackson has told the story of the ragged man on a park bench who, on being asked why he did not save for a rainy day, replied simply, "I did."

It was against this background that President Roosevelt in his annual message to Congress on January 4, 1935, recommended among other things "social security against the major hazards and vicissitudes of life." In his Social Security Message on January 17, he followed up by asking Congress for four types of legislation looking to economic security: unemployment compensation, old-age benefits, Federal aid to dependent children and additional Federal aid to state and local public agencies.

The Wagner-Doughton-Lewis bill was immediately introduced into Congress. It paved the way, first, for providing Federal grants to the states for old-age assistance, vocational rehabilitation, expanded public health service, aid to dependent children, maternal and child health services, child welfare services and aid for crippled children and, second,

for a system of unemployment compensation and old-age benefits to be financed by pay-roll taxes. Each part of the program, except old-age benefits, required supplementary state action. The old-age insurance system was to be administered by the Federal Government. To encourage the installation of unemployment insurance plans by the states and to secure uniformity in those plans among the states a 90-percent credit against the Federal tax was allowed for contributions made by employers under any state unemployment compensation fund approved by the Social Security Board. The social security bill was based upon a report of the President's Cabinet Committee on Economic Security, appointed in 1934, consisting of Secretaries Perkins, Morgenthau and Wallace; Mr. Cummings, the Attorney General; and Mr. Hopkins, the Federal Emergency Relief Administrator.

Business and industrial groups were opposed to the principle of such a measure. Their argument was succinctly stated two years later before the Supreme Court. Recalling to the court the "virtues of self-reliance and frugality," Counsel said there was a "possibility" that "aid from a paternal government may sap those sturdy virtues and breed a race of weaklings." Representative Knutson of Minnesota was gloomy; he thought pay-roll taxes would retard business recovery by driving many industries into bankruptcy. Criticism also came from groups farther to the left who favored the Townsend-Lundeen demand for more liberal benefit payments.

Mr. Morgenthau, Secretary of the Treasury, also objected and asked for changes in the bill so that the financing of contributory old-age insurance would be put on a self-supporting basis with Federal contributions entirely eliminated. He recommended increased pay-roll and earnings taxes, a change which meant that a huge reserve would be built up in the Treasury—nearly $50,000,000,000 by 1980. He also asked for the exemption of agricultural labor, transient or casual labor and persons in domestic service. Within a few years advocates of broader social security coverage would be bending their efforts to nullify Congressional assent to this request.

The House bill was passed in April. The Senate offered many amendments; one of the few accepted by the conferees was a title providing aid for the needy blind. The bill which became law was predominantly a House measure. In signing the act on August 14, 1935, the President called it:

> a cornerstone in a structure which is being built but is by no means complete . . . a structure intended to lessen the force of possible future depressions. . . . It is, in short, a law that will take care of human needs and at the same time provide for the United States an economic structure of vastly greater soundness.

The Social Security Act elicited howls of indignation from many rugged individualists who had learned nothing from the depression the country had just experienced. A college president told a commencement gathering: "Most of you believe in social security for the old, but I would rather see a few old people suffer than see the race go soft." A segment of the press flayed the measure as an unwarranted intrusion by the government into the affairs of private citizens. The whole plan was excoriated as un-American; it had been imported lock, stock and barrel from abroad. The *New York Sun* printed a fearsome story headed "New Deal Will Tag Workers." In a picture next to the story was a regimented victim of social security, stripped to the waist and wearing a metal tag on a chain around his neck. A Western newspaper began substituting social security numbers for by-lines over reporters' stories. The editor signed himself 525-10-9454.

The act was also subjected to severe criticism in other directions. Some of this criticism was aimed at the amount of benefits and the economic effects of pay-roll taxes, but the most vigorous attack was made on the fiscal provisions for old-age insurance, chiefly the provisions for the large reserve. It was argued that the reserve might be squandered, or borrowed and used for current government expense. The difficulty of investing such a large reserve without disturbing the money market was cited. The required return of 3 percent was more than some government bonds were paying currently, and the difference would have to be made up by the taxpayer. Finally, it was argued that the reserve might not be sufficient to pay all the benefits required by 1970, which would mean that other taxes would have to be imposed by that time.

These criticisms were sufficiently powerful to lead a Social Security subcommittee of the Senate Finance Committee and the Social Security Board to appoint an Advisory Council in 1937 to study the old-age insurance features of the act. This council represented three groups—employers, employees and the general public. The report submitted at the end of 1938 by Chairman J. Douglas Brown of Princeton

University recommended enlarging the scope of the benefits, extending the system to cover more of the population and improving the financial program. Among the financial recommendations was a proposal that the Federal Government eventually contribute a share equal to the shares contributed by employers and employees, making each group contribute one-third.

The Treasury immediately borrowed Mr. Brown. In March 1939 the Secretary of the Treasury appeared before the Ways and Means Committee, asking for changes in the fiscal provisions of the act. He advocated that the full reserve principle be abandoned and that the reserve be retained at an amount not more than three times the highest prospective annual benefit payments in the ensuing five years. In a euphemistic mood he also suggested calling social security taxes "contributions" in order to improve public understanding of the purpose for which the funds were collected. A little later Chairman Altmeyer of the Social Security Board also suggested extensive changes designed to broaden coverage and increase benefits. He made it clear to the committee that eventually a government contribution would be required to carry the additional cost.

The final results of these changes were the amendments of 1939 which made the old-age insurance program a system of old-age and survivors insurance. The system was broadened to provide monthly allowances for dependents and to give old-age beneficiaries with dependents a higher proportion of former wages than those without dependents. The average amount of benefits payable in the early years was increased and the eligibility requirements were liberalized to provide protection for more people who were aged or approaching retirement age. The tax on both employers and employees, originally designed to begin at 1 percent and gradually to increase to 3 percent, was frozen at 1 percent through 1942.

It is fortunate for the country that the constitutional attack upon the Social Security Act reached the Supreme Court in the climate of opinion of 1937. The margin of constitutional victory was thin even then. The Unemployment Compensation Act of Alabama, set up in conformity with the Federal law, was declared constitutional in Carmichael *v.* Southern Coal Co.,[1] decided on May 24, 1937, in an opinion written by Mr. Justice (the late Chief Justice) Stone. The Four Horse-

[1] 301 U. S. 495 (1937).

men—Justices McReynolds, Butler, Sutherland and Van Devanter—dissented.

Mr. Justice Cardozo wrote the majority opinions of the same date in Steward Machine Co. *v.* Davis,[1] which sustained the tax upon employers, and Helvering *v.* Davis,[2] which sustained the Federal old-age insurance provisions. The distinguished jurist knocked the historical prop from under the argument that employment was not a privilege which could be taxed by pointing to a Virginia tax of 1780 upon white servants. "Our colonial forebears," he said, "knew more about ways of taxing than some of their descendants seem to be willing to concede." The Fifth Amendment was not offended; nor was the Tenth by the collateral hope of ulterior aim beyond taxation. "There was need of help from the nation if the people were not to starve." For 150 years of American history there had never been a case before the Supreme Court which required it to interpret the general welfare clause of the Constitution. It was "too late today," Mr. Justice Cardozo said for a slim majority of the court, "for the argument to be heard with tolerance that in a crisis so extreme the use of the moneys of the nation to relieve the unemployed and their dependents is a use for any purpose narrower than the general welfare." In the Helvering case he added:

> Needs that were narrow or parochial a century ago may be interwoven in our day with the well-being of the nation. What is critical or urgent changes with the times. . . . But the ill is all one, or at least not greatly different, whether men are thrown out of work because there is no longer work to do or because the disabilities of age make them incapable of doing it. Rescue becomes necessary irrespective of the cause. The hope behind this statute is to save men and women from the rigors of the poorhouse as well as from the haunting fear that such a lot awaits them when journey's end is near.

To Mr. Justice McReynolds the majority opinion was a "cloud of words" and an "ostentatious parade of irrelevant statistics" which obscured the fact that the majority opinion annihilated the theory he had supposed was firmly established that the states, as well as the Union, were indestructible. The outraged justice defined his principles by reciting the entire message of President Franklin Pierce to the Senate

[1] 301 U. S. 548 (1937).
[2] 301 U. S. 619 (1937).

on May 3, 1854, in which President Pierce vetoed the grant of public lands to the states for the benefit of indigent insane persons. President Pierce argued that the Federal Government was not concerned with the fate of the local insane. Mr. Justice Butler could not base his judicial judgment upon the political philosophy of a proslave politician of over three-quarters of a century ago, and wrote a separate opinion. Mr. Justice Sutherland delivered another dissenting opinion in which Mr. Justice Van Devanter concurred. These last two justices questioned only certain administrative provisions of the statute. No one has since questioned the constitutionality of the act which was designed to protect the average citizen and his family against the loss of a job and poverty-ridden old age.

Chapter 8

THE UNDISTRIBUTED PROFITS TAX AND "CLEVER LITTLE SCHEMES"

1936-1939

THE year 1936 started with calm tax weather. On January 3 President Roosevelt said in his annual message that he was requesting no new taxes. He may not have known that less than a month before a distinguished advocate had argued the famous AAA case before the court the President would later try to "pack." Mr. George Wharton Pepper knew his law, but he knew much more. At the end of his "fleeting" time before the court he added a "final and personal word":

> I have tried very hard to argue this case calmly and dispassionately, and without vehement attack upon things which I cannot approve, and I have done it thus because it seems to me that this is the best way in which an advocate can discharge his duty to this Court.
>
> But I do not want your Honors to think that my feelings are not involved, and that my emotions are not deeply stirred. Indeed, may it please your Honors, I believe I am standing here today to plead the cause of the America I have loved; and I pray Almighty God that not in my time may "the land of the regimented" be accepted as a worthy substitute for "the land of the free."

The unreconstituted Supreme Court had not recovered from this eloquence on January 6 when Mr. Justice Roberts, speaking for the majority, held the Agricultural Adjustment Act unconstitutional.[1] Three justices—Stone, Brandeis and Cardozo—could do no more than

[1] United States *v.* Butler, 297 U. S. 1 (1936).

dissent against a decision which they characterized as a "tortured construction of the Constitution," and which affected in an amount of more than $1,000,000,000 a budget which was "in balance" except for relief expenditures. In vain did Mr. Justice Stone remind the majority that "courts are not the only agency of government that must be assumed to have capacity to govern." His eloquence was equal to the occasion when he added:

> . . . interpretation of our great charter of government which proceeds on any assumption that the responsibility for the preservation of our institutions is the exclusive concern of any one of the three branches of government, or that it alone can save them from destruction is far more likely, in the long run, "to obliterate the constituent members" of "an indestructible union of indestructible states" than the frank recognition that language, even of a constitution, may mean what it says: that the power to tax and spend includes the power to relieve a nation-wide economic maladjustment by conditional gifts of money.

Obviously a crisis confronted the revenue. On March 3 the President addressed a special message to Congress. There may have been some who wished the AAA ruling had been a less conclusive victory, for Mr. Roosevelt suggested an undistributed profits tax on corporations. Under the plan proposed by the President the undistributed profits tax was designed to replace all other corporation taxes and become an adjunct of the individual income tax. Corporate income would be taxed only once, either as individual income or as undistributed profits. The idea was not new. It had been a hobby of Senator Andrieus Jones of New Mexico as far back as 1917. Dr. Adams had made much the same proposal in 1919. Secretary of the Treasury Houston had suggested a similar measure in 1920, and so had the Joint Committee on Internal Revenue Taxation in 1928. But these precedents were forgotten in the storm of protest which greeted the President's "radical" proposal.

Opposition to the tax was not rationalized at first and took the familiar form of disparagement of its so-called backers. The proposal was traced to such "leftist" advisers as Herman Oliphant, General Counsel of the Treasury, and Mr. Rexford Guy Tugwell of the AAA. It was a "soak-the-rich" scheme aimed at corporations and their "economic royalist"

directorates. Mr. Crowther, a member of the Ways and Means Committee, found some comfort in the fact that "all the brain trusters" did not think alike. Raymond Moley said that forcing industry to pay out all of its earnings in good years would accentuate booms and would make employment precarious in years of depression. In the debate over whether the mortality of corporations would be greater under the new plan than the old, Mr. Knutson metaphorically opined that "this law would provide for sending flowers to the deceased." The disgruntled Mr. Moley later confessed to wondering "whether the search for the Holy Grail of a just national economy wasn't being transformed into a strafing expedition." Arthur Krock did not wait to express his opinion on "this reckless essay in Federal financing." He thought the "episode" of the administration's corporate surplus tax proposals would stand out in history among the "bewildering adventures of the New Deal."

Representative Fred M. Vinson, of Kentucky, an administration stalwart who was destined to become Secretary of the Treasury at the end of World War II and subsequently Chief Justice of the United States, introduced the measure in the House. Chairman Doughton successfully defended the tax against the arguments of colleagues on the Ways and Means Committee, even the favorite charge that the plan was "in accord with Tugwellian philosophy" and had "communist approval." For once the minority complained that it was without benefit of the views of Secretary Morgenthau.

Before the Senate Finance Committee Mr. Ellsworth Alvord spearheaded the attack of the businessman. He "shuddered to contemplate the consequences of a virtually complete uprooting . . . and the substitution of new statutory provisions, in an unknown and unexplored field, piled upon the present complexities of computing taxable net income, and with the government and the taxpayer sharing dollar for dollar in the error." Senator King led a revolt in the Finance Committee, with Senators Byrd and Connally supporting him, the latter for the reason, however, that the measure would bear unfairly upon the small stockholder, freeze business and prevent small concerns from expanding. The committee was thought to be preparing to "throw a curve ball"—that is, to offer a bill it knew would be changed materially on the Senate floor or in conference.

The debate on the floor of the Senate anxious to adjourn for party conventions was unusual. Almost the only supporters of the admin-

istration's original proposal were LaFollette, a Progressive, Norris, a Republican—and one Democrat, Hugo Black. A compromise measure emerged from conference, with the House winning on the principle of taxing undistributed corporate profits and the Senate winning on the principle of retaining the normal tax on corporate earnings. The exemption of dividend income from the normal tax, which had been in effect since 1913, was repealed. The United States Chamber of Commerce released a statement saying that the compromise measure embodied a destructive theory of taxation and "would retard recovery and discourage re-employment." It is certainly true that the final bill contained almost every bad suggestion made in the course of passage and retained few of the virtues of the original proposal.

In May of 1936 government controls over economic and social conditions received another blow. The Supreme Court invalidated the Bituminous Coal Conservation Act[1] on essentially the same ground that induced it to hold the NIRA to be unconstitutional—as an unauthorized invasion of state powers and an improper delegation of authority. The act was designed to lift a "sick" coal industry out of the depression quagmire by providing that minimum and maximum prices were to be fixed and that minimum wages, maximum hours and collective bargaining were to be established. In 1935 the President had urged Congress to pass the Guffey Coal Bill, maintaining that "doubts as to constitutionality, however reasonable" ought not be permitted to block its enactment into law. Doubts became certainty when a majority of a divided court decided that the labor provisions of the 1935 Act were unconstitutional and that the labor and pricing provisions were not separable. The entire act fell. In the meantime, the plan to put "new blood, new vigor, new experience and new outlook" into the Supreme Court was taking shape.

Mr. Roosevelt's economic royalists of 1936 had better reason than they knew to oppose his re-election. He had heard strange tidings. A friend reported that a prominent New York financier had blatantly remarked to a group at an exclusive Parisian bar: "My fortune is in the Bahama Islands, and is going to stay there as long as that bastard is in the White House." Mr. Roosevelt was both amused and astonished. Further information came to him on the high seas. His friend, Mr. Vanderbilt, told him a story of how yachts were being incorpo-

[1] Carter *v.* Carter Coal Company, 298 U. S. 238 (1936).

rated, not by Mr. Vanderbilt, but by many of his acquaintances. Man of action and words, the President sent a message to Congress on June 1, 1937, quoting a letter from the Secretary of the Treasury which revealed efforts at tax avoidance and evasion "so widespread and so amazing both in their boldness and their ingenuity" that further action without delay seemed "imperative." The President was "indignant." "Clever little schemes" were not admirable when they undermined the foundations of society. The "decency of American morals" was involved. He was confident that Congress would wish to enact legislation to make the "present tax structure evasion-proof."

Witnesses at public hearings before the Joint Committee on Tax Evasion and Avoidance from June 17 to July 28 described schemes and mentioned names. The "red herring" investigation was filling the papers with scandalous detail. Lights burned late in a feverish and unprepared Treasury which assembled an outside group, including Thurman Arnold, Abe Fortas and me, to work on an inside committee. A hot summer was cooler than many tempers. Avoiders resented publicity. Mr. J. P. Morgan uttered the indiscretion of a lifetime: "If the government does not know how to collect its taxes, a man is a fool to pay them."

An almost unbelievable tale unfolded. In order to siphon assets and income out of the United States, prominent American citizens had deserted the protection and advantages of the established corporate laws of their country in favor of the corporate laws of an insignificant foreign island in the Atlantic Ocean, principally known as a winter pleasure resort, and the laws of other neighboring foreign jurisdictions such as the Bahama Islands, Panama, Newfoundland and Prince Edward Island. Some American taxpayers were making elaborate and artificial attempts to secure fictitious interest deductions on what purported to be indebtedness represented by so-called loans from a company incorporated in the Bahama Islands which masqueraded as an insurance company. Domestic "incorporated pocketbooks," formed to insulate interest and dividends from the individual income tax, had multiplied like mushrooms. The owners of farms, racing stables and other hobbies, as well as yachts, had incorporated their pleasures to make them businesses. Multiple trusts were being used to obtain additional personal exemptions and to split income into separate units, each of which would start with a low tax bracket. Leading cartoonists, violinists and

motion-picture actors were resorting to the device of incorporating their personal talents.

The response of Congress was prompt. By August 26, 1937, the President was able to sign the Revenue Act of 1937, a measure designed to repel this attack upon the "foundations of society." The act did not make the tax structure "evasion-proof," but it closed for good and all a number of loopholes which the President had called to the attention of Congress. The new act, written as an amendment to three titles of the 1936 Act, taxed the income of foreign personal holding companies to their United States shareholders. Provisions increasing the surtax upon domestic personal holding companies, tightening the definition of those companies, and denying certain deductions formerly allowable, resulted in a practical death sentence upon the use of domestic personal holding companies for tax avoidance. Further provisions served to prevent the use of the device of incorporating yachts and country estates. A change in the family loss section was made, denying the deduction of certain losses on family transactions and transactions with related corporations. A modification prohibited the deduction of expenses or interest which was not paid within the year, or within a short period thereafter. The inclusion of personal service income in personal holding company income closed the incorporated talent loophole. Congress thought that existing law adequately reached the foreign insurance company avoidance scheme. The 1937 Act also eliminated a discrimination in the 1936 Act in favor of nonresident aliens and foreign corporations. The new measure made a small and insufficient change in the treatment of multiple trusts, but did not attempt to deal with community property, family partnerships, pension trusts and percentage depletion, subjects which had also been mentioned by the President.

The year 1937 had opened with serene economic optimism. It marked the high point in recovery since 1932. The pessimistic prediction of the Chamber of Commerce had failed to materialize. But in August business slowed down and a "recession" was noted. (People were becoming euphemistic.) The recovery of 1934-1937 had been based upon expansion of consumer installment credit supporting purchases of automobiles, refrigerators and other durable goods, and by some $14,000,000,000 of Federal expenditures for recovery and relief. Rearmament in Europe, which started a price inflation of raw materials; the drought in

America, which shot up the prices of agricultural commodities; free spending as a result of the soldiers' bonus payment in the last half of 1936; and the labor upheaval were all contributory factors. The recession, which rapidly developed into a menacing depression, came when these stimuli gave out.

A subcommittee of the Ways and Means Committee had been at work for some time on a study of needed tax revision. Its report to the full committee, which included a recommendation to retain the undistributed profits tax, was made on the basis of public hearings in January 1938. Mr. Roswell Magill, Under Secretary of the Treasury, defended this aspect of the report, arguing that there was no convincing evidence that either the undistributed profits tax or the capital gains tax had been a major factor in the business recession. The skeptical Representative Treadway disagreed. So did Mr. Bernard M. Baruch, a prominent Democrat; shortly thereafter he testified before Senator Byrnes's Committee on Unemployment and Relief to his opinion that these two taxes had unfortunate economic effects. By this time business had rationalized its objections to the undistributed profits tax: the tax flouted the principle of ability to pay; it was unsound, unfair and discriminating; it aided monopoly; it penalized initiative and enterprise; it imposed conditions on taxpayers which they could not meet; and it inflicted penalties upon "a statutory, arbitrary . . . concept of taxable net income whereas the only fund under state law which is available for the declaration of dividends is earnings and profits." Mr. Winthrop W. Aldrich of the Chase National Bank and Mr. Owen D. Young of the General Electric Company testified that the tax would hinder the flow of investment capital. Mr. G. H. Houston, president of the Baldwin Locomotive Works, said it would help destroy the system of private enterprise.

These arguments were effective in the House only to the extent of eliminating the so-called "third basket" tax, an additional tax on closely held corporations. But the Senate was more impressed. The Finance Committee thought the House plan would obstruct "the free flow of capital into productive enterprises." Chairman Harrison considered the tax a "beautiful theory," but he was convinced that it had proved harmful. Lawyers could not understand it. Senator Ashurst compared the Treasury to a "spoilsman with a game bag." Mixing his metaphors, he added: "We cannot continue to take a policeman's billet and pound

the taxpayer on the head if we expect to achieve recovery." Only Senators Barkley and LaFollette defended the tax; the former thought it had not been sufficiently tried and the latter that its elimination would be a step backward.

The conference committee made its usual compromise under pressure from a President who requested that the principle of the undistributed profits tax be retained. After a deadlock of almost a month the House managers won approval for their undistributed profits tax, but the Senate managers secured its limitation to the years 1938 and 1939. On May 27, 1938, the President broadcast a speech at a high school commencement at Arthurdale, West Virginia, in which he expressed disapproval of the curtailment of the undistributed profits tax and the abandonment of the progressive tax principle in the treatment of capital gains in the bill. Then, following the example of President Cleveland in 1894, he allowed it to become a law without his signature.

The objectors to the undistributed profits tax found a willing listener in the affable new Under Secretary of the Treasury, Mr. John W. Hanes. A new administration attitude developed out of the 1937 recession. Secretary Morgenthau and Mr. Harry Hopkins delivered business appeasement talks. Mr. Hanes announced his belief in a tax system which "preserves and increases the incentives that are essential to the perpetuation of free enterprise in a nation of free men." The President remained persistently loyal to the undistributed profits tax. But his Secretary of the Treasury seemed more bent upon the elimination of "tax irritants," of which this tax was notably one. A bill was quickly passed in 1939 to appease business, which had won its long and determined fight. This finale had a "Battle of Blenheim" flavor:

> "But what good came of it at last?"
> Quoth little Peterkin.
> "Why, that I cannot tell," said he;
> "But 'twas a famous victory."

Chapter 9

SHADOWS OF WORLD WAR II

THE President was a hard loser. His undistributed profits tax was discarded in the Revenue Act of 1939, enacted June 29, 1939. On September 1 Germany invaded Poland and two days later Great Britain and France declared war on the Reich. World War II was under way. Almost immediately Mr. Roosevelt turned his attention to the possibility of an excess-profits tax and other changes in the tax structure which would help to produce more revenue. In November, after having been summoned to the White House for several consultations, I delivered two memoranda to the President. The first dealt with possible changes in the tax law which would substantially increase revenue by eliminating discriminations in the income, estate and gift taxes. The second presented a general plan for taxing the excess profits expected as part of the impact of war upon the American economy.

The events of 1939 ushered in a new era of history. War news spread quickly and reactions were various. The young Senator Lodge of this generation said: "We can't stay out." Senator Barkley was thoughtful: "There are some people who believe that if Congress had done what the President asked and amended the Neutrality Act, there would not be a war in Europe today." An Italian-American looked up from his bootblack's stand in New York and asked simply: "For what? I went over before. For what I went over?" Prime Minister Chamberlain was filled with anguish: "Everything that I have worked for, everything that I have hoped for, everything that I have believed in during my public life has crashed into ruins." A Chinese statesman was more philosophical, but no more optimistic. Looking out of his window, he observed wistfully: "The sky is black with the wings of chickens coming home to roost."

After World War I the American people had held high hopes for

permanent peace. In January of 1918 Mr. Wilson had stated the ideals for which the nation was fighting in his famous Fourteen Points. He had sailed for the Paris Peace Conference in December, a month after the Armistice was signed, with his plan for a League of Nations. But he had gone without the support at home which he had so earnestly sought. Public opinion appeared to be overwhelmingly behind the League. But Mr. Wilson's appeal to American voters for a Democratic Congress to sustain him in negotiating the peace had been spurned. The people had resented Presidential interference in local elections and a Republican majority was returned in both Houses of Congress. In the two years of debate which followed, the League of Nations was defeated and with it the Treaty of Versailles, thanks in large measure to the efforts of the elder Senator Lodge. The Massachusetts Senator employed no frontal attack; he merely kept the country in the iron grip of a political deadlock. He burked the League Covenant by opposing its imperfections; his strategy was the insidious and indirect method of reservations. The votes indicated that a majority of the Senate favored the League, with reservations, but no majority could agree on the exact reservations.

The Republican platform of 1920 had been, in William Allen White's phrase, a Machiavellian Pandora's box, accepted by Messrs. Hoover, Taft and Root as pro-League and by others as anti-League. While campaigning, Mr. Harding had said he favored with all his heart an Association of Nations "so organized and so participated in as to make the actual attainment of peace a reasonable possibility." But after his election the Association of Nations went by the board. In March of 1920 the Versailles Pact had been rejected by the Senate by a vote which fell seven short of the two-thirds necessary to ratify. The Harding administration tossed it into the scrap heap. "No entangling alliances" was the current shibboleth. The people had become indifferent to the fate of the League. Woodrow Wilson had warned them—wisely in the light of subsequent events—that if they rejected the League they would be obliged to fight another World War in twenty years. He had also told them: "I would rather fail in an enterprise that I know must some day succeed than succeed in an enterprise that I know some day must fail." But most of the people paid no heed. The slow but sure retreat into isolationism had begun.

There was, however, a vocal segment of public opinion which de-

manded that something be done for "peace," and Mr. Harding called the Washington Conference of 1921. Its purpose was to end naval rivalry and to settle Pacific difficulties. At that time the first naval limitation agreement in modern history was reached; Great Britain, the United States and Japan agreed to stop their naval race for a specified time and accepted a 5-5-3 ratio for limiting the size of their battleship fleets. Peace enthusiasts saw the dawning of a new day. Taxpayers welcomed the idea of relief from the costs of military preparedness.

In 1927 President Coolidge tried but failed to obtain further limitation of naval armaments at the abortive Geneva Conference. The Hoover administration also stressed the disarmament issue. In 1930 the President inaugurated the London Naval Conference which suspended the replacement program for British, American and Japanese fleets and adopted a holiday for battleship construction until 1936.

Other events cast their grotesque shadows. In 1928, sixty-one nations, including the three Axis powers, signed the Pact of Paris in which they renounced war as an instrument of national policy and promised never to seek the settlement of disputes except by pacific means. Optimists basked in the warm comfort that war had at last received its death wound. But the solitary accomplishment of that antiwar pact was to do away with declarations of war. Then, too, after more than a decade of intermittent debate the United States Senate finally refused to let this country become a member of the World Court, except with reservations which the other members of the court could not and would not accept.

By the summer of 1931 the fetters of Versailles which bound Germany had rotted one by one. In less than two years' time Adolf Hitler would rise to power and within another two years an insolvent Germany would manage to rearm in violation of the Versailles Treaty. In September a mysterious explosion occurred on the Manchurian railway near Mukden. By January of 1932 all of Manchuria had been occupied. To "avenge Japan's honor" a great Asiatic nation would be cut to pieces because it was unarmed and torn by internal conflicts. In 1935 Benito Mussolini, Italy's self-styled Man of Destiny, would launch his braggart "little war" for the conquest of Ethiopia; in less than ten years he was destined to be a ghoulish ornament on a public square of Milan. In Spain, on the balcony of Europe, an obscure militarist

named Francisco Franco would dream of temporal power. The brief age of the new Caesars was on its way.

For a short time in 1933 international economics held the center of the stage. Manufacturing guns instead of butter had become the policy of certain nations as a means of providing employment. An International Economic Conference was called in London; it was hoped that the nations of the world would find in talk some panacea for their economic ills. The conference was a dismal failure. Critics of President Roosevelt charged that he sabotaged the meeting when he sent a "realistic" radio message rejecting the stabilization proposals of the British and French Governments. The President contended that the gold-bloc nations were seeking "a purely limited objective and were unwilling to go to the root of national and international problems." In the storm of dissension currency stabilization, a freer flow of world trade and international action to raise price levels were relegated to the place of things that might have been.

The Nye investigation, begun in 1934, had disclosed a sinister story of international intrigues and war profiteering. The brave new world of which countless Americans had dreamed throughout the years of the war for democracy was shattered. The inability of most of our associates in the war to pay their debts added to the general disillusionment. In 1934 the Johnson Act, forbidding further loans to foreign governments that had repudiated their war debts, was passed. Swept by a wave of antiwar sentiment, Congress in 1935 hastily passed the first Neutrality Act, declaring that if and when there was a war, the United States would be neutral. The act also imposed an embargo on the export of arms, munitions and implements of war to all belligerents. The embargo was to be applied "impartially" with no distinction between aggressors and victims of aggression. The President was given no discretion. In signing the act President Roosevelt said that its "inflexible provisions might drag us into war instead of keeping us out."

In 1936 Spain became the testing ground of Nazi and Fascist armor against the might of the dreaded Kremlin. In 1937, after years of fighting, Japan and China were definitely at war. That same year the Rome-Berlin Axis was proclaimed. In Chicago, the heart of isolationism, President Roosevelt, far ahead of popular sentiment, asked

that aggressor nations be quarantined. He made clear his warning that if the plague of international lawlessness, already apparent in the world, were permitted to spread, "let no one imagine that America would escape." The dictators did not like this forthright language. But hardly an American voice was raised to express agreement with the President's views. In January of 1938 Mr. Roosevelt asked Congress for a super-Navy bill which would prepare the way for a two-ocean Navy. Even from across the Atlantic it was becoming possible to compute the shrinking interval of peace.

In March of 1938 Hitler marched into Austria and the shameful appeasement year had begun. Hitler's crowning triumph came at Munich in September where the bankruptcy of the European democracies was revealed and the doom of Czechoslovakia was sealed. Prime Minister Chamberlain arrived with a furled umbrella which proved a better protection against rain than against war. But for a little while he cherished the comfortable belief that "peace in our time" had been secured. In rapid succession came the German annexation of Czechoslovakia; the Italian conquest of Ethiopia; and the Nazi-Soviet Pact, which freed the Reich for eighteen months from the necessity of war on two fronts and at the same time gave Russia an opportunity to arm.

In July 1939 President Roosevelt unsuccessfully tried to obtain repeal of the arms embargo provisions of the Neutrality Act, which tied this country's hands against selling arms to the European democracies for defense against German aggression. Senator Borah told a group assembled at the White House that his own private information was better than that of the State Department. He said that there would be no war in Europe.

A few weeks later the German Wehrmacht was slicing up Poland. The long-threatening storm broke over Europe at last. In a sad, tired voice Mr. Chamberlain announced over the radio that Great Britain and Germany were now at war. Change with its long arm, its disturbing touch, its decree of things not yet manifest, had come. It would tear almost every life from its moorings. It would disestablish nearly all that was secure in human affairs. In November Congress opened the American munitions trade to belligerents on a cash-and-carry basis. Later that month Russia, which was destined to arise from its scorched earth to become the leading military power of Europe, invaded Finland.

In April 1940 Germany overran Denmark and Norway; in May, Holland and Belgium. By June Fascism stood clearly triumphant, threatening to engulf the world. The impregnable Maginot Line had been flanked, the Battle of France was over, and the greatest army in Europe had been destroyed and captured by a new technique. Unconquered England, no longer ruler of the waves, had beaten a gallant retreat from the European continent and waited defenseless for an invasion that mysteriously did not come.

Some Americans watched the agonies of the nations across the sea and murmured: "There but for the grace of God go I." But many others stood confused between the warnings of the myopic isolationists and the pleas of the farsighted interventionists. In some quarters the awful holocaust was written off as a "phony" war. In the United States business was going on very much as usual. One ocean divided us from Europe and another from Asia. We forgot that the Western Hemisphere was elbow to elbow with places conquered, or about to be conquered. We forgot that freedom was not necessarily ours passively to have and to hold in perpetuity. We had the greatest productive machine and the greatest natural resources in the world. But our present efforts were not enough. We lacked a sense of urgency at the very hour when signs and signals pointed to full speed ahead. On December 29, 1940, President Roosevelt appealed to the American people for more ships, more guns and more planes—more of everything. We must be the great "arsenal of democracy." The defense of the United States depended upon the rapidity with which American industry converted to war.

In January of 1941 the President entered upon an unprecedented third term amid the prospect of attack by both Germany and Japan, once the other nations strong enough to resist them had been vanquished. He stated our war aims in his annual message to Congress. We looked forward to a world founded upon four essential freedoms: freedom of speech and expression, freedom of religious worship, freedom from want and freedom from fear. Mr. Roosevelt then asked Congress for a piece of legislation "of the most comprehensive nature." To the European democracies it was aid short of war; to the United States it was a substitute for war. Strong conflicting cross-currents in American opinion were aroused. As a people, we wanted to bring about the defeat of Hitler and his allies without committing our-

selves to any dangerous obligations. The curious paradox in the formula, "Aid to Britain—short of war," symbolized the schism in the American soul. The endless debate, although too few realized it, was over the question: to be or not to be. But the people believed they were debating a less elementary question: how to keep out of foreign wars while others bled and died before a foe on whose list America was next.

Congress responded in March with the Lend-Lease Act which Mr. Churchill called "the most unsordid act in the whole of recorded history." It was the United States' practical and dramatic notice to the world that we intended to help those nations which were resisting aggression. But in August the House of Representatives voted to extend selective military service for another eighteen months by the hairline margin of 203 to 202. In August also Mr. Churchill and Mr. Roosevelt, at a dramatic meeting on the foggy seas of the Newfoundland bight, issued a joint declaration of eight bases for world peace, which was destined to go down in history as the Atlantic Charter.

But in a few months a decade of international immorality would reach its climax. In a moment the myth of American naval preparedness would be dispelled. Our naval, land and air forces would be decimated in a Hawaiian harbor by treacherous surprise attack. The United States would be bombed by the Japanese into war at the very moment when conversations looking toward the maintenance of peace in the Pacific were under way. It was only a matter of time until the American budget for one year would be $100,000,000,000.

Chapter 10

TAKING THE PROFITS OUT OF WAR

1940-1941

1. *Taxing for Defense: First Revenue Act of 1940*

THE German successes in the terrifying spring of 1940 had their effect upon American tax policy. The public debt had now reached over $40,000,000,000, but there was no escape from additional appropriations for a larger Army, the modernization of Army and Navy equipment and increased production for national defense. On May 16 the President delivered a message to Congress in person, requesting additional appropriations and authorizations of $1,200,000,000 for national defense. There was no noticeable dissent until Colonel Charles A. Lindbergh three days later demanded by radio that America "stop this hysterical chatter of calamity and invasion. No one wishes to attack us and no one is in a position to do so."

Congress acceded quickly to the President's request. Contrary to the usual practice with revenue legislation, a bill was worked out in advance of public hearings. On May 27 and 28 a Congressional group, consisting of Chairman Doughton and Mr. Cooper of the Ways and Means Committee and Chairman Harrison of the Senate Finance Committee, met with Secretary Morgenthau to discuss tax plans. Following the meeting, the Congressional leaders issued a joint statement announcing that they had agreed to ask Congress to consider legislation to provide funds for payment of the national defense program. They said they would propose (1) an increase in the national debt authorization of $3,000,000,000 to provide for the issuance of national defense obliga-

tions with maturities not to exceed five years, and (2) the levy of additional taxes to yield between $600,000,000 and $700,000,000 annually over the five-year period, sufficient to liquidate the national defense securities. They said that this program met with Presidential approval.

On May 30 Chairman Doughton introduced a bill embodying the joint tax program, and on May 31 hearings were opened. Even then the newspapers were carrying stories that the President was planning to send a message to Congress with additional recommendations on national defense. The message came the same day. The "incredible events" of the last two weeks necessitated another enlargement of our military program. Mr. Roosevelt asked Congress for an additional $1,300,000,000 for national defense.

The first Revenue Act of 1940 became law on June 25, 1940. It embodied a larger borrowing and taxing program than the Congressional leaders had agreed to in May. It extended the debt limit by $4,000,000,000, rather than $3,000,000,000, to permit the issuance of $4,000,000,000 of defense bonds. It provided revenue to pay off the bonds over a five-year period by increasing individual surtaxes in most brackets, slightly increasing corporate rates, and imposing a five-year "defense" supertax amounting to about 10 percent on most existing internal revenue taxes. It broadened the individual income tax base by reducing personal exemptions from $2,500 to $2,000 for married persons and from $1,000 to $800 for single persons. Mr. Treadway, happily unable to see into the future, told the House that this act was going to "startle" the taxpayers when they realized its enormity.

The verdict contained in the first Revenue Act of 1940 was hardly unanimous. A Republican minority, paying mandarin courtesy to the necessity of providing funds for meeting defense needs, double-talked in favor of reduced expenditures. It cited a remark of the Secretary of the Treasury that the government of the United States would be "broke" by the following February. Mr. Treadway and his colleagues were depressed. The public debt had reached the "staggering and unprecedented" level of $45,000,000,000, a figure which "no one ever dreamed would be reached when originally fixed by Congress." The final conclusion was that "the only substantial source of revenue" left for the Federal Government was a general sales tax.

2. *Revival of the Excess-Profits Tax: Second Revenue Act of 1940*

The first 1940 Revenue Act was only a temporary expedient. A question extending beyond fiscal policy could no longer be postponed—the question of the extent to which the government should permit profits to be made out of a national emergency. In 1917 the American Legion had demanded a universal draft act "to place at the disposal of the government, without profit to any one person, the men, money and material resources of the nation." In 1924 both major political party platforms had pledged that in event of war every resource should be drafted. During the two decades between World War I and World War II, Congress had repeatedly gone on record against war profiteering. The Senate had created the Nye Committee in 1934 to study the munitions industry. A seamy tale of profits figures had unfolded during its investigations. Eager to secure materials, Army and Navy officials had paid little heed to manufacturing costs or the earnings of private manufacturers. The Nye report revealed that on Treasury audits the profits of shipbuilding companies showed up to 90 percent. Officials of one company had professed "amazement" when their profits on two cruisers, estimated at about 10 percent, actually turned out to be over 35 percent. Bills for entertainment in connection with trial trips, keel layings and launchings were included as a matter of course in the cost of ships and were paid for by the government. An official of one large shipbuilding company frankly admitted that wines, liquors and cigars were considered "as important elements in the shipbuilding business as steel" and were, therefore, charged into wartime contracts as proper expense.

The Vinson-Trammell Act, limiting profits on naval aircraft and vessels to 10 percent had been passed in 1934. It had been extended in 1939 to include Army aircraft, and the rate on aircraft had been raised to 12 percent. The Merchant Marine Act had been passed in 1936; in addition to giving financial assistance to the shipping industry, it limited profits on merchant vessels. In June, shortly before the 1940 recess for party conventions, the Senate Naval Affairs Committee learned that the Navy had let a billion dollars' worth of shipbuilding contracts without competitive bidding, on the World War I basis of cost plus 10

percent. Congress lost no time in revising the Vinson-Trammell Act to lower the profit limits on plane and ship contracts. Strangely enough, following this action the Treasury was accused of believing that patriotism rather than a desire for profits should motivate industry.

In reporting out the first revenue bill of 1940, the Ways and Means Committee had said that the rearmament program should furnish no opportunity "for the creation of new war millionaires or the further substantial enrichment of already wealthy persons." But the committee had concluded that it would take too long to work out the complicated problems involved in excess-profits taxation to include an excess-profits tax in the 1940 Act. The Senate had adopted an amendment by Senator Connally providing for a war-profits tax and an amendment by Senator LaFollette providing for an excess-profits tax. In conference both amendments were rejected, but a resolution stating that "an excess-profits tax should be enacted as soon as possible" was adopted.

The Vinson-Trammell Act, even as amended, was inadequate; its rigid limitations based upon contract price discriminated severely among contractors, favoring subcontractors and material men over prime contractors. Again I was called to the Treasury as a consultant and a group of us—including John L. Sullivan, Assistant Secretary; Roy Blough, Director of the Division of Tax Research; and Thomas Tarleau, Tax Legislative Counsel—began drafting a Presidential communication to Congress, to be taken to the White House by Secretary Morgenthau. Our work was abruptly interrupted when Mr. Sullivan read to the rest of us a ticker story flashing the President's own communication of July 1, 1940. Mr. Roosevelt had drafted a short, but emphatic, message in a rare spare moment, and had forwarded it to Congress on his own initiative. His message urged that the additional burden of national defense be "equitably distributed according to ability to pay so that a few do not gain from the sacrifices of the many," and suggested a steeply graduated excess-profits tax to be applied to individuals and corporations "without discrimination." This was in accord with the promise he had made on May 22 that "not a single war millionaire will be created in this country as a result of the war disaster."

Following a conference of Congressional tax leaders and representatives of government agencies at the White House on July 10, a state-

ment defining the scope of the proposed legislation was issued. I had little difficulty in persuading the President that the excess-profits tax should not be applied to individuals already subject to high surtaxes. It was agreed that the excess-profits tax bill would incorporate a provision for writing off in five years the cost of additional facilities necessary for national defense, and that the bill, which would apply to all industries, would be substituted for the profit-limiting provisions of the Vinson-Trammell Act.

The Second Revenue Act of 1940 was approved on October 8, 1940. It imposed a tax on corporate "excess" profits levied at graduated rates reaching a maximum of 50 percent. It suspended the profit limitations imposed by the Vinson-Trammell Act and certain limitations under the Merchant Marine Act. It increased the normal tax on corporations, and it contained a special provision for amortizing facilities necessary for national defense. These facilities might be written off over a five-year period, or less if the war ended sooner. This right was granted irrespective of the postwar value of the facilities, most of which would have a postwar use. Firms with emergency facilities were, in effect, given funds for reconversion through a reduction in their wartime tax base.

The principal quarrel of the Second Revenue Act of 1940 related to the theory of the excess-profits credit. Some device was necessary for measuring normal profits and segregating them from the excess profits which were to be taxed. Various technical methods were therefore adopted to determine the amount of normal profits which would be exempt from the excess-profits tax, and the segregation was accomplished by means of a corresponding credit, to be used in computing excess-profits tax liability. Two methods were provided for computing the amount of the excess-profits credit: the average-earnings method and the invested-capital method. The earnings method was based on the theory that earnings during the taxable year which were in excess of earnings during the base period—the four years immediately preceding the outbreak of the war—were defense profits and should be specially taxed. The inference was that defense profits were being made out of the sacrifices of the people as a whole and should be returned to the people in taxes. The invested-capital method was based on the theory that the sole standard of excessiveness of profits was in relation to a rate of return on invested capital. There were two ways

of determining the rate of return: the first would use an arbitrary percentage as a norm and the second would use the actual rate of return on capital in the base period.

The Treasury favored the latter method which combined the average-earnings and invested-capital standards. It advocated a plan under which corporations were to be subject to an excess-profits tax on income in excess of $5,000 plus a normal return on invested capital. The normal return was to equal the average rate of return on invested capital for the 1936-1939 base period with a floor of 6 percent on the first $500,000 of invested capital and 4 percent on the amount above $500,000, and a ceiling of 10 percent. New capital and borrowed capital were to be exempted.

Under the Treasury plan, despite very low earnings in the base period, current year earnings might increase to a minimum return on invested capital without special taxation. High earnings in the base period were required to contribute the excess over a specified return in special war taxation. Aggregate profits greater than those in the base period would be free of special taxation only if the investment were increased.

The Joint Committee on Internal Revenue Taxation presented a plan which differed notably from the Treasury plan in allowing in full the taxpayer's average earnings in the base period as a credit in determining what profits were excessive, regardless of how high base-period earnings might have been. It provided an alternative standard representing a low rate of return on invested capital for corporations with very low earnings in the base period.

The House bill was a compromise. It contained one credit based upon earnings and invested capital according to the Treasury formula and another credit based upon earnings according to the Joint Committee plan. The taxpayer could either compare its average earnings in the base period with its earnings for the taxable year or it could compare the base-period rate of return on invested capital with the current year return. The use of the average-earnings credit was penalized by a rate schedule higher than that applicable when the invested-capital credit was used, and further by an increase in the normal tax rate.

The Senate converted the average-earnings credit from a stepchild to a full member of the family. Differential penalty rates were eliminated in return for a reduction of from 100 to 95 percent in the amount

of average base-period net income which could be used. The invested-capital base-period rate of return was converted to a flat 8 percent.

Senator LaFollette did not hesitate to express strong minority views. He was for a permanent excess-profits tax based on invested capital. The oil of the invested-capital method and the water of the earnings method would not mix. He had considered the first 1940 Act "the most inequitable tax bill enacted by Congress in the last decade," because it had added only 1 percent to the corporation tax and imposed no tax on the mounting profits industry was garnering from national defense. Now the Finance Committee was reporting a second revenue bill to the Senate with excess-profits tax provisions which "violated every principle of sound taxation." The bill combined two "conflicting ideas of excess-profits taxation"; it gave great advantage to "large, prosperous corporations"; it "encouraged monopoly"; it was "neither reasonable nor equitable"; and it was "inexcusably complicated." LaFollette quoted the conservative National Economy League as saying that "the 'percent of invested capital method' of defining excess profits is theoretically preferable to the 'standard return' method, since it reaches all profits above a specified ratio and permits tax rates to be graduated according to profits rates."

3. *Relieving Hardship: Excess-Profits Tax Amendments of 1941*

It was anticipated that the Second Revenue Act of 1940 would soon need "liberalizing" amendment. This was partly accomplished in the Excess-Profits Tax Amendments of 1941, approved on March 7, 1941. The conference committee on the second 1940 bill had adopted a hasty provision to take care of unforeseeable situations by providing adjustments for abnormalities of both income and capital. The provision was known to be inadequate, but was inserted, according to Mr. Doughton, "as a token of assurance to taxpayers that further Congressional action would be taken in this respect." The House managers had then instructed the Treasury and the staff of the Joint Committee on Internal Revenue Taxation to give additional study to the entire problem. The new legislation attempted to provide a set of flexible rules which would alleviate most of the severe hardship cases which might arise.

The 1941 amendments added a "growth formula" to the original

average-earnings credit provided by the second 1940 Act, the object of which was to prevent corporations whose facilities and productive capacities were substantially increased during the base period from being penalized as compared to corporations which had already achieved and maintained a high and constant level of production. A further provision was inserted to cure abnormalities in base-period net income. The possibility of substituting a constructive average base-period net income for an actual average base-period net income not representative of normal earning power indicated an increased emphasis on this type of excess-profits credit. The amendments also permitted a two-year carry-over of unused excess-profits credits. The allowance of this credit carry-over was designed to relieve the hardships caused by sharply fluctuating earnings of many types of companies and to benefit new corporations and old corporations undergoing a period of expansion.

4. *Taxes Go Higher: Revenue Act of 1941*

In the spring of 1941 the government was collecting considerable revenue from the excess-profits tax, but the profits of many corporations that were the principal beneficiaries of the defense effort and of government contracts were being lightly tapped or were not being tapped at all. The excess-profits measures so far adopted had failed signally to achieve the objective that profits growing out of the defense effort should be subject to the excess-profits tax. Mr. Sullivan told the Ways and Means Committee in May that one company with $70,000,000 of war orders was subject to no excess-profits tax on 1940 earnings, although its profits in 1940 were more than 3,000 percent larger than in 1939.

According to the Assistant Secretary of the Treasury, another serious shortcoming of the 1940 excess-profits tax law was that profits in excess of normal return on invested capital were not subject to the tax unless those profits also represented an increase in the profits over the base period. Some companies making 30 or 50 percent or more were not subject to the tax, if they made that amount during the base period. The Assistant Secretary pointed out that this failure of the law to reach a large proportion of the profits of these corporations was due to the provision giving a credit to every corporation equal to 95 percent of its

base-period earnings, regardless of the size of those earnings in relation to its invested capital.

The Treasury submitted to the Ways and Means Committee a revised plan which broadened and strengthened the excess-profits tax. The plan wiped out the existing option to use average base-period earnings in computing the excess-profits credit, and so basically involved a reversion to the Treasury's original 1940 proposal for an excess-profits tax based solely on the invested-capital method. At the same time, however, the Treasury suggested as a possible alternative to an excess-profits tax the adoption of a higher corporation income tax with a reduction in the tax when corporate profits were immediately included in the individual stockholder's taxable income.

The Revenue Act of 1941, approved September 20 of that year, went far beyond corporate territory. Appropriations, authorizations and recommendations for national defense had risen to $50,000,000,000. The deficit for the month of August was running at the annual rate of nearly $14,000,000,000. In July, after three months of consideration, the Ways and Means Committee proposed a bill to raise $3,500,000,000. This then unprecedented sum was based on the proposition advanced in April by Secretary Morgenthau that expenditures during the emergency should be financed two-thirds by taxes and one-third by borrowing. As defense expenditures increased, the dangers of inflation were mounting. The prolonged cost-of-living rise was in its fifth month. The committee proposed to raise the needed revenue by increasing individual surtaxes, estate, gift and excise rates, and by imposing new excises. In the corporate field additional revenue was to be obtained by imposing a surtax on corporations, by increasing excess-profits rates to a maximum of 60 percent, by imposing a special 10-percent tax on the difference between average earnings and the invested-capital credit, by reducing invested-capital percentages, and by no longer allowing the corporate income tax to be deducted in computing the excess-profits tax. In addition, capital-stock tax rates were to be raised. The committee also adopted a provision requiring husbands and wives to file joint returns. This provision, designed to yield $300,000,000, was stricken on the House floor.

Again a Republican minority had supplemental views. The defense program had reached "astronomical" magnitudes. The minority recognized the necessity of increasing the tax burden and had no alterna-

tive but to support the general objectives of the bill. But the failure of the national credit and the collapse of the nation's political structure appeared imminent to the minority. The time had come to point the finger of blame. The New Deal "wastrels" had engaged in the greatest peacetime orgy of extravagance in all history. In eight years they had spent over $66,000,000,000, as much as it cost to run the government during its first 131 years, from the administration of George Washington through the administration of Woodrow Wilson, including the World War I period. They had accumulated a series of "staggering annual deficits" which had piled up the national debt to the point where even the necessary borrowing for defense would "seriously jeopardize the public credit." They had "taxed and taxed until the available sources of Federal revenue" had been "all but exhausted." This was a curious statement in view of the fact that revenue receipts increased from $7,362,000,000 in 1941 to nearly $44,000,000,000 in 1945. Thirteen major tax measures had been enacted, the statement continued, and the tax burden was "50 percent greater than under the World War I revenue acts."

The minority recalled the "wise counsel" expressed in the "President's since forgotten economy message of March 10, 1933," in which he had cited recent history to prove that liberal governments had been "wrecked on rocks of loose fiscal policy." Finally the minority patted its own back by showing how it had co-operated "on a strictly nonpartisan basis" in endeavoring to help the Democratic majority "produce the best possible measure under all the circumstances."

The Senate increased the yield of the House bill principally from the corporate surtax and the individual income tax. The 10-percent defense tax of the first Revenue Act of 1940 was integrated with other taxes. The special 10-percent tax on companies using the invested-capital credit was rejected. A Senate amendment providing an optional simplified return for certain incomes of $3,000 or less was accepted by the House managers in conference. A community property amendment adopted by the Finance Committee was stricken on the Senate floor. As a result of this action and the House decision to eliminate the joint return provision, it was necessary in conference to obtain approximately $300,000,000 in revenue by reducing the personal exemption of married persons from $2,000 to $1,500, and of single persons from $800 to $750. Exemptions were at their lowest since the Federal income tax was

adopted in 1913. The whisky tax had now reached $4 per proof gallon.

Individual views were expressed by Mr. Vandenberg, the able senior Senator from Michigan, who reluctantly supported the bill because the worst kind of a tax bill would be better than no bill at all. He said the war and defense era had been preceded by an eight-year spending spree "without parallel in the history of the world," and that "nondefense economies—plus our 'money's worth,' instead of wild waste in defense expenditures—are just as important as new taxes in saving this situation." He thought that we must

> quit the free-and-easy notion that the Treasury of the United States is inexhaustible. We must quit the complacent, convenient notion of the last prodigal decade that debts are an asset. We must "go to war" against our spendthrifts long before we "go to war" against another enemy 3,000 miles away. We may be relatively rich. But we do not possess Aladdin's lamp. Simple arithmetic cannot be repealed even by the New Deal.

The "distinguished" Secretary's "pious formula"—a two-thirds pay-as-you-go basis—was "already out the window." It would probably be impossible to do much more than the bill did "without wrecking our internal economy" which was already threatened by priorities and price controls and curtailments and taxes. But we owed it to ourselves, the Senator thought, and to those abroad, realistically to determine how far, short of war, we could underwrite the war bills of the world. "We cannot be content with a bankrupt Utopia."

Senator LaFollette also had his own views on the bill. He lambasted it as "inadequate," "inequitable" and "indefensible." Its "hodge-podge of inconsistencies" in taxing individual incomes and commodities with a severity out of line with corporation taxes made an "intolerable tax structure infinitely worse."

The Revenue Act of 1941 contained no changes in the average-earnings credit; but again Congress emphatically reaffirmed the credit against the last attempt of the Treasury to strike it from the statute. The rate of permissible return on invested capital was somewhat reduced, and a special allowance was made for capital invested after 1940. Although relatively the invested-capital credit was made less attractive and the average-earnings credit more attractive, more companies were using the invested-capital credit. The 10-percent tax on the

amount of adjusted excess-profits net income saved from the excess-profits tax by the use of the invested-capital credit, rather than the average-earnings credit, was defeated. This action refused to impose an additional tax upon war profits realized by corporations which had not had a rate of return from 1936 to 1939 as high as the allowable return on invested capital. The act also contained a reversal of the order of deductions; the income tax was no longer deductible in computing the excess-profits tax.

Chapter II

BRAKING INFLATION

1942

THE year 1941 had brought Germany three major mortal enemies in place of one and the end of all hope of an early victory. For the first time as a New Year dawned Adolf Hitler failed to predict triumph in the coming year, but promised "still harder battles for 1942 if we are to circumscribe the powerful foe that confronts us."

On this side of the Atlantic the foe was being welded into the greatest coalition in history. On January 1, 1942, representatives of twenty-six nations from every part of the globe signed a declaration in Washington formally pledging themselves to employ their full resources against the Axis powers and to enter into no separate armistice or peace. "United Nations" became words of inspiration and hope. The term signified wholehearted union for victory and the salvation of a desperately shaken world.

On January 2, as the United States Army fought with its back to the wall in far-off Luzon, Manila fell to the Japanese invaders and this nation drank the unaccustomed and bitter draught of defeat in battle. On January 6, thirty days after we entered the war, President Roosevelt drew a blueprint for the mightiest armament program in history. We were going to be a superarsenal as well as a front-line combatant in the fight against aggression. In his State of the Union Message the President announced that he had ordered immediate steps to be taken

> to increase our production rate of airplanes so rapidly that in this year, 1942, we shall produce 60,000 planes; . . . so that next year, 1943, we shall produce 125,000 planes; . . . in 1942, 45,000 tanks . . . and . . . next year, 1943, . . . 75,000 tanks; in 1942 . . . 20,000 anti-aircraft guns . . . and so that next year, 1943, we shall produce 35,000. . . .

Congress was "stunned," some observers said. William S. Knudsen and Sidney Hillman, the Office of Production Management chiefs, declared: "We will do it!" Our Allies were heartened; the British called it "the greatest national effort ever known." Dr. Joseph Goebbels, Propaganda Minister of the Third Reich, scoffed: "Bluff! Fantastic! Bombastic!"

The President's arms blueprint meant that America's unmatched industrial plant would have to turn out a plane every four minutes, a tank every seven minutes and two ships a day. It meant that the pace of conversion from civilian to war production must be swiftly accelerated. It meant that new production equipment would have to be built on a breath-taking scale. The slogans "business as usual" and "guns as well as butter," hopes of a year ago, sank with our battleships at Pearl Harbor. The new program meant the dislocation of our economy; it meant hardship and sacrifice. But hardship and sacrifice were the price of freedom, and the price would be paid.

On January 7 President Roosevelt presented his first war budget. It called for expenditures of $59,000,000,000 for the fiscal year 1943. The President offered no assurance that this astronomical figure might not be exceeded. Almost 95 percent of the budget—$56,000,000,000—was earmarked for defense. Financial considerations had been thrown overboard. Economy had become unsound. Sound fiscal policies were those which would help win the war.

The Budget Message called for $7,000,000,000 in additional taxes and an additional $2,000,000,000 from the social security program. This would leave almost $40,000,000,000 to be borrowed. But events moved faster than figures could be assembled. Original goals became obsolete even before they could be reached. On April 24 a budget revision added $14,000,000,000 to war expenditures. The war in Europe was in a dismal phase. The most optimistic judges were estimating that Britain might last ten months. On October 7 a second revision added another $7,000,000,000 to the war budget. Taking into account nonwar governmental outlays, total expenditures were thus projected at $85,000,000,000—$600 for every man, woman and child in the country—or nearly three times the $33,000,000,000 spent during the three years, 1917-1919, of World War I. The country was spending, solely for war purposes, $100,000,000 a day, a figure which would rise at the high point of war spending to over $250,000,000 a day.

The wheels of American industry gathered speed in production for a foreign front, but a new enemy threatened the home front. It was an insidious enemy which would constantly threaten and, unlike Germany and Japan, is still undefeated. The flood of money in the country had grown dangerously high. Inflation was no longer something that might hit sometime; it had gained a tight hold on the national economy. Food prices were paralleling the upward trend of World War I; the prices of other commodities were ascending at a slower, but still disturbing, rate. The cost of living had gone up 15 percent since the autumn of 1939. Of this increase about 80 percent had come within the last year. The turbulent Leon Henderson, Administrator of the Office of Price Administration, talked ominously of the "inflationary gap." He estimated that living costs would rise at least 23 percent more in 1942 unless drastic steps were taken. Retail prices were going up about 2 percent a month. The OPA reported that inflation had cost the government $2,500,000,000 out of the $18,000,000,000 spent for defense between August 1939 and the end of 1941. If "runaway" inflation were permitted, the war cost might be increased as much as $50,000,000,000 by the end of 1943. Later possibilities were almost unimaginable.

The record indicated that the forces making for further price rises might become so powerful that they could not be stopped unless all of us—Congress, the administration and the people—fought them on all fronts with all the strength at our command. On April 27 the President sent a message to Congress outlining seven "musts" of national economic policy. It was a large order. To keep the cost of living from spiraling upward we must tax heavily, fix ceilings on prices and rents, stabilize wages and farm prices, put more billions into War Bonds, ration all essential scarce commodities, discourage credit and installment buying, and encourage savings and the paying off of debts. The American economy could not be allowed to drift; laissez-faire as a doctrine had gone with the wind of dramatic new days.

In May Mr. Henderson clamped down the over-all price ceiling, the General Maximum Price Regulation, which in Washington jargon became known as General Max. It directed that no retailer could sell goods for more than his March prices. The regulation applied to almost every article sold. The one big exception was farm products which Congress exempted from price ceilings until they should reach certain levels, one of which was 110 percent of parity.

With many commodities scarcity was becoming the rule rather than the exception. Full war production could have no other result. The situation was critical. Price ceilings could never insure the efficient distribution at a reasonable price of goods made scarce by the war. Something more was needed. The more was rationing. It began with tires and sugar and gasoline, but it did not end there. In time many of the comforts of life would go glimmering and many necessities would be hard to buy. Because gasoline and rubber were unavailable, people went back to an older method of locomotion; the lowly pedestrian returned to his former estate. The Federal Reserve Board placed dampers on retail credit by restricting installment buying; open charge accounts could no longer run over seventy days. A peacetime economy was changing into a wartime economy. The American people were becoming intimate with their government as they had never been before.

Contrasts had new colors. The job before the war had been to stimulate trade and industry by coaxing dollars out of their stagnant hiding places and into the market. The old name for this objective was spending ourselves into prosperity. A name had lost its value. At last we were spending ourselves into prosperity. But it was no longer a crime to spend.

Spending was an intoxicating habit. National income had risen from $40,000,000,000 in 1932 to $71,000,000,000 in 1939. But, to borrow from Mr. Churchill, this was "not even the end of the beginning." In 1943 national income reached $148,000,000,000, or $111,000,000,000 at 1939 prices. In the thirties some niggardly voluntary spending failed to produce prosperity. In the forties some extravagant involuntary spending had produced prosperity. Economics had a new philosophy.

In 1942 it was estimated that in 1943 individual income payments after taxes would exceed by $40,000,000,000 the amount of goods and services available to consumers valued at 1942 prices. Assuming that the people were to save $25,000,000,000 of that $40,000,000,000, they would still have left $15,000,000,000 of spending power in excess of goods and services available. Actually, at that time, no one was able to foresee the response of the economy to greater production. As it turned out, more consumers' goods were produced in 1943 than had been predicted and, in the absence of durable goods such as automobiles and refrigerators, consumers were willing to save more than was thought possible. Nevertheless, there remained a substantial volume

of excess spending power which threatened to break through Mr. Henderson's price ceilings.

The secret of this condition was an open book. From a prewar goal of increasing spending, the country had come to a war goal of reducing spending. When conversion to war had begun, there had been a substantial reserve of unemployed natural and human resources. Although many of the depression unemployed had found work by 1940, in that year a large supply of untapped manpower still remained. Raw materials were abundant. Partly or wholly idle factories were available to expand production. By using these idle materials and facilities, by adding new capacity, by using hitherto unemployed workers and by training new workers, we had been able for about a year and a half to increase armament output and at the same time to augment the supply of civilian goods. As consumers, we had simultaneously more money and more things to buy. Both our money income and our real income had reached an all-time high. But the end was in sight. Money income would continue. But real income must break if the war were to be prosecuted speedily to victory.

At this stage the real cost of producing the implements of war—the extra toil and sweat, the added pressure, the sacrifice of comforts—often seemed remote and unreal. The new wage earner regarded his job, even though it meant hard work, as a blessing rather than a burden. His higher wages enabled him to buy more goods and services. Because civilian output was expanded, no one else was denied goods and services when a new worker received more pay. The United States was still the land of full dinner pails.

But the major part of American industry was shifting from the products of peace to the weapons of war. It was no longer possible to depend entirely upon the employment of equipment and labor that formerly had been idle. It was necessary to tap other sources, to develop new supplies of labor—on the one hand drawing upon women and old people and, on the other hand, training much of the existing labor force in higher skills. It was necessary drastically to curtail private construction and the production of private capital goods. Instead of maintaining, replacing and adding to existing equipment in a normal way, we were delivering the sinews of war to a three-continent battle front. The rapidly expanding armament program also made inroads on another supplemental source of war production—stocks of basic raw materials.

Could depleted stock piles of rubber, strategic metals and scrap materials be replaced? That was a crucial question which only the future would tell.

Until now unemployed facilities, deferred replacement and construction, and stock piles had been sufficient to provide the major part of the war output. We had been living off our economic fat. Only one segment of consumer output—automobiles, refrigerators, stoves and other "hard goods"—had been diverted to the war effort.

By 1942 these halcyon days were history. The needs of total war played no favorites with sources of increased output. To meet insatiable demands, equipment and labor had to be shifted from the production of the comforts, and even some of the things that people deemed the necessities, of life to the production of the implements of war. More tanks, planes and guns and more food for many armies meant fewer automobiles, less heat, less clothing and even less of many kinds of food; yet money income was plentiful. But winning the war was the first order of business; houses, streets, transportation facilities and, in considerable measure, factories and equipment devoted to the production of consumers' goods, had to go without replacements and expansion.

The bolt had not come from the blue. The dwindling supply of consumers' goods and services could be temporarily concealed by bulging inventories. For a time stores had been able to continue to furnish goods from ample stocks. But late in 1942 the protective covering of inventories was wearing thin in dozens of places. Bare spots on store shelves were becoming commonplace. The scarcity of nylon stockings and of rubber products was headline news; but these shortages were only a symbol of what was occurring in many places, and only a foretaste of what was to come. Each new shortage diverted purchasing power into other channels, creating further shortages and bringing the real cost of war closer home.

The real cost of war could not be expressed in conventional monetary symbols. But it was evident in the new routine of daily life. It became apparent in 1942 that more Americans would have to work more in 1943. There would be a restricted supply of goods and services for greater exertions. These hard physical facts could not be camouflaged by pleasant phrases. Neither taxes nor any other economic

measures could change the picture. Harder work on the one hand, and fewer goods and services on the other, constituted the price civilians must pay to win the war. They were the inescapable real cost of the war.

The cost must be met by this country. It could not be shifted to foreign countries. America would not, like the Axis, obtain resources by looting conquered territory. It could not, because of the limitations of the industrial capacity of the neutrals and its Allies, obtain substantial resources by buying goods from abroad. It must do its own job and make its own payment.

It must do so now. The real cost of the war could not be shifted to the future. Borrowing dollars at home could in no sense postpone present hardships. No financial legerdemain could transfer civilian goods and services from the future to the present. By no financial manipulation could we bomb Berlin and Tokyo today with bombers to be built in 1952. Posterity could not arm existing fighting forces. The tools to fight the war could come only out of current living or expansion of our total production. There was no choice between paying for the war now and postponing the economic cost to the future. The only choice lay in how the cost was to be distributed among the people.

The physical realities of hard work and short supplies had their monetary counterpart. An increasingly intensive mobilization of resources meant augmented incomes for workers and investors. The short supply of consumers' goods meant that there was relatively little for these incomes to buy. The result was a paradox of large incomes and short supplies. Increased income had no place to go. It lay smoldering in millions of pockets. It was an explosive factor in the economy.

The question was whether this purchasing power should be allowed to flow freely to the market for consumers' goods and services. If it were, a wild competition for a restricted supply of goods was inevitable. Black markets would mushroom. Evasion and dealer favoritism would become commonplace. Empty shelves and illegitimate profits would become the order of the day. The distribution of the restricted supply of the necessities of life would be wasteful and inequitable. Competition to buy these necessities would be reduced to a disorderly, time-consuming scramble. The goods and services would go not to those

who needed them most, but to those who were least bound by limitations of time, money and scruples. The ensuing hardships would be suffered particularly by families in the low income groups.

This method of distributing limited supplies is the method of inflation. It was used both here and abroad in the last war. It was being used here now by default rather than by design. But inflation is the least satisfactory method of distributing short supplies. It is a method intelligent men would never explicitly choose. It imposes the heaviest burden on those who can least afford sacrifice and the lightest burden on those who can best afford sacrifice. Rising prices hit persons with fixed incomes much harder than persons with rising incomes. They affect persons with low incomes, who must ordinarily spend all they earn for goods and services, more heavily than persons with high incomes, who can maintain their standards of living despite higher prices.

Inflation also disorganizes the economic process. Business is generally conducted in terms of prices that are expected to remain fairly stable. Rapid price increases shift the emphasis from production as a source of profit to speculation and hoarding as a source of profit. The struggle of labor to keep wages in line with ever-rising prices adds to the confusion. If inflation takes precedence over production as the main concern of business and labor, any war effort can hardly fail to suffer.

Furthermore, inflation multiplies the monetary costs of war and raises economic problems for years to come. If a given supply of war goods rises in price, it is necessary either to raise taxes or to float more debt. The wake of inflation is always a disjointed price system, which promotes a policy of "watch and wait" until prices are again in line. Once they get in line—that is, when they descend from inflationary heights—debts incurred at high levels are immeasurably harder to pay. The great farm debt was one of the most disastrous economic legacies of the inflation suffered in World War I.

These dangers of inflation made its control absolutely imperative. And it seemed clear as early as 1942 that direct controls, such as price ceilings, rationing and the regulation of consumer credit, would be insufficient by themselves to halt the upward course of prices. The pressure was almost certain to be too great. Consumers must be induced to refrain from spending about $40,000,000,000 annually, or about $4 out of every $11 of income at their disposal after existing

taxes. In this crisis taxes and increased savings seemed the most available reinforcements.

Taxes promised to perform certain functions better than direct controls, and also to do a job that direct controls could not do. Furthermore, taxes were cheaper than inflation. Price ceilings resisted the upward pressure of prices by pushing down from above. Wage controls and fixed farm prices offered partial relief by preventing the creation of additional surplus purchasing power. But taxes would strike at the root of inflation. They would cut down existing purchasing power. In addition, they would reduce the need for administrative controls, which in turn would reduce the overhead of wartime government and increase everyone's personal freedom.

Taxes promised to accomplish still other desirable objectives. They would restrict the accumulation of public debt. This would reduce the postwar interest burden, and thus ease the problem of postwar debt management. The government would, therefore, be in a better position to deal with the economic problems of the postwar period.

Savings could also be of immense value in keeping direct controls from collapse. Like taxes saving would immobilize spending power; saving, whether voluntary or compulsory, had advantages compared with taxation. Work incentives might more readily survive savings levies. Workers might be willing to work harder and longer if they felt that they were only temporarily deprived of the fruits of their labor and that they might enjoy those fruits after the war when goods would once more be abundant. Moreover, such a promise of future reward justified a greater restriction of consumption in the lower income groups. Greater total levies might be acceptable if a promissory note, or claim against the future, were substituted for a tax receipt. And finally, saving would create a reserve of purchasing power for the postwar period.

There was one drawback in this last advantage. Too great accumulated savings might not be a totally unmixed blessing. A pool of potential consumer purchasing power would have dangers. A new supply of civilian goods in the postwar period might cause a conversion of capital assets into cash. Securities might be sold, billions might be borrowed on insurance policies, at a time when bank balances and currency in circulation already exceeded all records. Such potential purchasing power might easily burst into an uncontrollable flash flood of spending.

In 1942 there were many champions of compulsory saving, which was a method of increasing and turning the key on savings so that they could not be spent until after the war. Among these champions were Leon Henderson; Marriner Eccles, Chairman of the Federal Reserve Board; and Harold Smith, Director of the Budget. They argued that everyone should be obliged to lend his wealth to the government in a period of emergency, and that the voluntary savings system advocated by Secretary Morgenthau would permit many to escape this responsibility and would be inadequate to secure the required amount of individual savings.

Some people who used the term "compulsory saving" meant compulsory lending, which is quite different from compulsory saving both in nature and in effect. The legal obligation to lend to the government an amount equaling a specified fraction of income, expenditure or other base, is quite different from the legal obligation to save a specified fraction of income. By drawing on previously accumulated assets, an individual could lend to the government and yet not save. Or he might save and yet lend nothing to the government. A small-scale example of compulsory lending was the postwar credit under the Victory tax, as it was enacted in 1942. However, the offsets against this lending for various forms of saving such as the payment of insurance premiums, the repayment of debt, and the voluntary purchase of eligible War Bonds converted the Victory tax credits very largely into an example of compulsory saving.

Compulsory saving might have been much more effective than compulsory lending in reducing civilian spending, if it could have been administered. But it was beset with administrative stumbling blocks. It was absolutely crucial to the saving plan not only to have a knowledge of each person's income and family status, but also to obtain a snapshot of his capital position at the beginning and the end of the period in which he was obligated to save. Such snapshots would be the only means of protecting the compulsory saving plan from being undermined by the use of existing balances and credits. To secure a picture of changes in capital position presented a new and difficult, although not an impossible, administrative task. But more formidable was the difficulty of enforcing saving out of income as it was received. Obligations would be based upon a fact before it became a fact, because the saving requirement could not be known precisely until income was

known, and income could not be known precisely until the period had ended.

The advocates of compulsory saving were thinking of the term in its broadest sense. Their proposals concentrated on compulsory lending, but they would have welcomed any other saving scheme which had compulsory features as distinguished from the purely voluntary system of War Bond purchases being used by the Treasury. Secretary Morgenthau stood almost alone in favor of voluntary saving, although at one point early in 1943 he was temporarily persuaded to accept compulsory saving, and later in the fall of 1943 he reluctantly consented to a plan for postwar tax rebate which was essentially a compulsory lending scheme. The controversy within the administration was sometimes bitter. While the President avoided any public statement in favor of either side, he allowed the Secretary of the Treasury to proceed in his own fashion. The argument finally subsided when the voluntary system had been in effect so long that it was too late for any change.

Inside the Treasury, in 1942, there were many friends—although I was not one—of a system of expenditure rationing to restrict consumer spending. This type of rationing would limit total consumer spending by fixing the maximum amount that every family or single individual was allowed to spend on rationed goods. It might quite properly be thought of as the complement of compulsory saving, which specified the amount which people must save. If the amount of spending on rationed goods were fixed, saving, in effect, became compulsory.

The spending allotment, like the saving requirement, would be fixed on the basis of family status and current income. Rationed goods would include almost all consumers' goods and services that had any current cost in labor, materials or facilities. Rents, tuition, medical care and a few other selected items might well be placed beyond the pale of the expenditure ration. Except for those items, however, consumers' goods could be bought only with a ration allowance. Within the allowance the consumer would be free to allocate his expenditures as he pleased. And, of course, people would be free to use income without restriction to make gifts, pay taxes and insurance premiums, buy real estate or securities or save in other ways. In fact, forcing diversion of income into such noninflationary channels was the very essence of expenditure rationing.

The over-all ration allowance for the entire economy during any given period would be determined by the demands of price stability. The object would be to limit the amount of rationed expenditure to the estimated value of the supply of rationed goods available during that period. In estimating that value, it would be possible to apply whatever price level it was desirable to maintain. Flexibility was a cardinal feature of the plan, for it would be relatively easy to change the total expenditure ration as more accurate data became available or as the expected supply position changed.

By its direct attack on the problem of excessive consumer purchasing power through the limitation of expenditure itself, this plan was capable not only of dealing inflation a body blow, but also of allocating the economic sacrifices of war fairly and precisely. The allotment of spending power to individuals or income classes could not be precise under a program of taxation or compulsory lending. Taking away income by taxes or enforced loans to the government would not necessarily force a reduction in consumption expenditure throughout the income scale. But the direct limitation of spending would facilitate both the over-all reduction in spending that was needed and the distribution of the reduction that was desired.

This instrument of control would have necessitated elaborate administrative machinery. It was for this reason that I was opposed to it. The ration limit could be enforced only through the use of a license to purchase, possibly in coupon form. The coupons would represent that part of income which could be spent on rationed goods, and might even be identified with money. Coupon distribution would be an enormous task, although it could probably have been accomplished through the active co-operation of employers, ration boards, banks and other institutions. But the difficulties of securing public co-operation with a complicated system of graduated rationing seemed to me to outweigh its economic advantages.

Still another plan to minimize the problems of direct control of spending was the spendings tax, submitted by the Treasury to the Senate Finance Committee in September 1942. The base of the spendings tax was consumption rather than income. The tax would be imposed on expenditures for consumers' goods and services. It would not be imposed on income received, and income saved would be specifically exempted. In fact, the spendings tax looked to the difference between

income received and income saved. Its base would be arrived at by subtracting from each person's income his net savings as evidenced by additions to his capital assets, including life insurance premiums and War Bond purchases, and reduction of his debts. Further deductions, such as rent, medical expenses and tuition, could be allowed, if desired, and the regular income tax would, of course, be deductible.

Except for the difference in base, the spendings tax structure would strongly resemble the income tax structure and would have much in common with compulsory lending and compulsory saving devices. Exemptions according to family status would be provided, and steeply graduated rates would be applied. For example, the first $1,000 spent on goods and services by a married man without dependents might be exempt. A tax penalty of 20 percent might be placed on the second $1,000 of consumption expenditure, 30 percent on the third $1,000, and successively steeper taxes on additional increments of spending. Rates might rise to 100 percent or more, depending on the desired restriction of spending. Part of the tax could be treated as a postwar rebate, if it were desired to combine compulsory lending with a tax on spending.

The spendings tax would reduce spending not only by directly withdrawing income in the form of taxes, but also by powerfully stimulating saving through a drastic penalty on spending. This penalty would not be levied indiscriminately on all spenders, but rather on those spenders who could best afford to pay and on that segment of spending which could best be reduced or eliminated. The differentiated exemption would enable persons with small incomes to obtain basic subsistence needs free of tax, while steep graduation would bring the full weight of the tax to bear on comforts and luxuries. The highest penalty rates would apply to those who were trying to obtain a disproportionate share of the reduced supply of civilian goods. The tax would be a powerful instrument for facilitating a fair distribution of the limited supply of goods and services available. In this respect it might be an important supplement to rationing. By placing a tax penalty on excessive expenditures, it might prevent some wealthy people from monopolizing the available supply of goods, thus leaving a larger share for those with more moderate means. By mopping up a part of the nervous dollars seeking outlets in consumer spending, the spendings tax might minimize the danger of major fissures in our price ceilings through the competitive bidding up of prices.

At the same time, the spendings tax would provide funds for war finance both by the revenue it collected and by the saving it stimulated. To the extent that it produced revenue, the Treasury would benefit. To the extent that individuals avoided the tax by not spending, inflationary pressure would be released. Although the resultant personal savings would not necessarily be paid over to the Treasury, they nonetheless would be removed from the spending stream and added to the pool of unspent income available for borrowing by the government, either directly from individuals or indirectly from financial institutions. The tax would also provide an increased measure of individual security and a backlog of purchasing power that would be available after the war when production could again be directed toward civilian needs.

The Treasury proposed that the spendings tax be administered within the existing income tax framework. The taxpayer would fill out a combined income and spendings tax form and would pay the two taxes together. Detailed records of expenditures would not be needed to enforce the tax. The total spendings figure on which the tax would be based would be derived indirectly by deducting, from the total amount of available funds, the amounts devoted to purposes other than personal consumption. To the data already required under the income tax would have to be added enough information to determine what changes in capital position took place during the period to which the tax applied. Immediate impact on spending could be assured by collecting a substantial part of the tax at the source.

The spendings tax recommended by the Treasury differed in one important respect from the spendings tax proposed by Ogden Mills in 1921 and advocated for many years by Professor Fisher of Yale. These gentlemen thought of the tax as a permanent part of our revenue system. The Treasury proposed the tax merely as a temporary war measure designed to curb inflation and raise more revenue. In the Treasury view the tax was undesirable as a permanent measure, since over the long span it would favor increased concentration of wealth in the higher income brackets at the expense of the people in the lower income brackets.

The spendings tax would have two important advantages over a sales tax. It would be possible under the spendings tax to provide the exemptions and deductions necessary to protect those whose low

standard of living threatened to impair their productive efficiency. It could also be adapted to the use of progressive rates. Thus the tax would differentiate among taxpayers on the basis of ability to pay and would distinguish between "luxury" and "nonluxury" spending. When a levy is applied to specific commodities, as under a sales tax, it is necessary to classify the commodities in order to establish rates according to some criterion of luxury. If the commodities are specifically enumerated, many knotty problems of definition arise, which add greatly to the administrative problem. If price is made the criterion, some goods are taxed at higher luxury rates merely because the goods are made to last longer. If prices go up generally, some commodities become luxuries merely because their prices have risen.

The spendings tax would not require difficult decisions as to what constitutes a luxury; the basis for graduating the rates would be the total spending of the individual. If his spendings were high, it would be presumed that they were devoted in part to luxuries, and they would be taxed accordingly. Furthermore, the spendings tax would make allowance for the size of a family, whereas the sales tax burden would increase with the number of dependents. The spendings tax would offer another advantage over the sales tax in that it would not tend to enter into production costs; hence it would not contribute to price inflation.

Moreover, the spendings tax would leave the taxpayer substantial latitude and freedom. He could decide upon the amount of his spendings. He could spend lavishly if he were willing to pay the price in higher taxes, but the inducement to postpone his spending would be strong. The decision he made would determine the size of his tax. Thus, to a considerable extent, he would be his own tax assessor.

Chapter 12

"THE GREATEST TAX BILL IN AMERICAN HISTORY": REVENUE ACT OF 1942

THE war tax problem was so vast that raising revenue and controlling inflation were only part of it. Incentives for increased production had to be balanced against the need for preserving a sense of unity which could come only through common sacrifice. A war could not be won by a divided people, and the people would be divided if some were allowed to profit excessively while others made the necessary sacrifices.

In September of 1941, a few days after the passage of the Revenue Act of 1941, Mr. Morgenthau had startled the House Banking and Currency Committee, as well as his own assistants, by stating that "in times like this" if a corporation earns 6 percent on its invested capital, it ought to be satisfied. The implication of this remark was a 100-percent tax on profits in excess of 6 percent. The committee members evinced a more than polite interest in the subject and interrogated the Secretary closely. Mr. Morgenthau said that he had no specific scheme in mind, and he did not explain whether he meant 6 percent to be the limit on profits after all taxes or that the regular corporate tax should apply to earnings limited to 6 percent of invested capital. He was possibly thinking of an excess-profits tax based on invested capital such as was levied in World War I. In any event, he was taking an early and courageous position, for profit making in time of war had many friends who finally assured the making of profits many times 6 percent of invested capital.

By 1942 the impact of war had revived many emotions which had led to earlier declarations against making profits out of war. In March

the National Association of Manufacturers urged that "all income over and above that needed to keep our business structure alive should be taxed to the limit—leaving only enough for survival." In April the United States Chamber of Commerce recommended "maximum rates on excess profits, going to 100 percent if possible." England had set the pattern. But bombs had fallen near the Houses of Parliament. They might fall on Capitol Hill; in 1942 this was considered more than a remote possibility. But as time went on and enemy bombers failed to arrive, the first blush of enthusiasm for the strict limitation of war profits waned into paler second thought.

A rationalization was forthcoming. War taxes should leave the economy in sound condition for the postwar period; the postwar health of corporations should be tenderly regarded. Many businesses had a unique opportunity to make up for the long lean years of the depression. A special amortization provision had been necessary in the Second Revenue Act of 1940 to tempt private capital into war plants. Pearl Harbor failed to accomplish a basic shift of attitudes toward profit making in wartime. The Secretary of the Treasury discovered, perhaps not to his surprise, that there could be a quarrel—opinions might differ as to whether it was a "fair" quarrel—"with the imposition upon corporations of a substantial proportion of the increased load of taxation required by our national peril," even though Americans were dying "for the maintenance of the very system of free enterprise which makes corporate profits possible." Donald Nelson, Chairman of the War Production Board, Under Secretary of the Navy Forrestal, Under Secretary of War Patterson, and Admiral Land, Chairman of the Maritime Commission, told Mr. Morgenthau's representatives—reluctantly, I think—that a corporate tax rate higher than 80 percent might endanger the full success of the war production program. They thought all taxes must be trimmed to the principal objective of securing production to win the war quickly.

On March 3, 1942, after weeks of intensive planning and consultation with other government departments, the Secretary of the Treasury presented his tax recommendations to the Ways and Means Committee. The spacious committee room was filled as the Secretary and his staff arrived. The committee sat intently at its circular desk. Camera bulbs flashed. All was attention as the Secretary in solemn tones recommended a program of $7,600,000,000 of increased taxes, "not as the maximum,

but as the very least that the American people can afford to provide at this critical time." To raise this sum he relied principally upon increased individual and corporate taxes, increased excises and the elimination of such "special privileges" as the exemption of state and municipal bond interest, depletion allowances on natural resource industries and separate returns by husband and wife living together. He also suggested that the pension trust, insurance company and capital gains provisions be substantially revised, and that the capital stock tax and declared-value excess-profits tax be repealed. Because it might soon become necessary to speed up tax collection to check inflationary price rises, he proposed collection of income taxes at the source at a rate within his discretion up to 10 percent. As a step toward simplification, he recommended elimination of the earned income credit.

The increased tax burden which this revenue program would impose upon taxpayers generally made provisions to alleviate undue hardship increasingly important. The Secretary recognized this situation, and his statement and my later statement to the Ways and Means Committee contained several relief suggestions. On March 30 I presented to the committee the Treasury's suggestions that credits be allowed for working wives and for children between the ages of 18 and 21 attending school, and that a deduction be allowed for extraordinary medical expenses. Later the Treasury made many further suggestions, including a provision for the special relief of corporations unjustly treated by the inflexible excess-profits tax.

Most of the Secretary's tax recommendations aroused bitter opposition in many quarters. The press was almost unanimously critical. One editorial writer could find "no indication in the Treasury's tax proposals of any serious intention to accept the implications of the simple fact that spending, not saving, creates inflation." The suggestions for liberalizing family income deductions were censured by another writer as an "obvious attempt to make more politically palatable" the Treasury's proposal for mandatory joint income tax returns for husband and wife. This proposal was also condemned as "cynically opportunistic" and "of dubious constitutionality"; it was further castigated as a "flagrant violation of the principle of ability to pay." Nearly all of the 350 persons who testified in the open hearings which lasted until April 17 opposed one or more features of the program, and frequently recommended programs of their own.

Some of those who testified urged alternative measures such as a sales tax. The National Retail Drygoods Association advocated a retail sales tax as "the easiest and the quickest and the way least disturbing to the economy of getting the money to achieve victory." The National Association of Manufacturers was "forced to the conclusion" that a sales tax must be enacted to raise the sums of money necessary. The United States Chamber of Commerce endorsed a 10-percent retail sales tax to siphon off another $5,800,000,000 from the "so-called" excess consumer purchasing power.

More rigid economy in the nondefense operations of Federal, state and local governments was constantly brought forward as a substitute for additional taxes. The National Economy League was advocating a reduction of nearly $2,000,000,000 in the Federal budget. In his prepared statement Secretary Morgenthau had urged severe economy as a "corollary" to the new tax program. Chairman Doughton expressed the opinion that if Congress demonstrated its intention to make substantial reductions in nondefense expenditures, it would have "a wholesome effect on the taxpayers of the country." The Joint Committee on Reduction of Nondefense Expenditures protested: "There is no room for nonessentials in a government stripped for action."

Curiously enough, some witnesses advocated tax reduction as, for instance, the elimination or reduction of the tax on capital gains. Mr. Emil Schram, president of the New York Stock Exchange, and others argued that the lowering of the capital gains tax would increase the revenue. The Treasury was recommending modification of the capital gain and loss provisions both for individuals and corporations in order to simplify the classification of transactions, to increase the maximum rate on net long-term capital gains of individuals in conformity with increases in rates on other income since 1938, and to permit short-term capital losses as a deduction against both short-term and long-term capital gains.

The Ways and Means Committee went into executive session on April 24. Day after day the committee met to discuss the many facets of the war tax problem and to consider specific proposals of the Treasury, the staff of the Joint Committee on Internal Revenue Taxation, and other suggestions made to individual members and relayed by them to the executive session. On May 6 an increased budget estimate of $14,000,000,000 and a steadily rising cost of living persuaded

a reluctant Secretary of the Treasury to recommend a lowering of personal exemptions from $750 to $600 for single persons, from $1,500 to $1,200 for married persons and from $400 to $300 for each dependent. This would raise another $1,100,000,000 of revenue and add about 7,000,000 new taxpayers to the tax rolls.

In the world outside the committee room the inflationary situation was growing disastrously black. Prices were surging against their controls with the force of an angry sea. On the morning of May 11, I telephoned Leon Henderson at ten minutes of ten and asked him to explain the dangers of inflation to a doubting committee. At 11:15, with apologies because he was speaking extemporaneously, Mr. Henderson testified in executive session. Except for Germany in the twenties and the pressure that came on France following World War I, Mr. Henderson knew of no major country which had as "inflammatory a situation as the one we face right here today." It would be impossible to control prices, he said, unless there was "large and substantial help" given in draining off purchasing power by the taxation method. The ordinary worker was going to have the most enormous rise in income he had ever witnessed, an income at least 50 or 60 percent above 1929. It was "highly important" to begin through taxes now, instead of at some later date, to tap this rise in income.

One of the most controversial developments of the executive session stemmed from a proposal made in the President's message of April 27. After recommending the taxation of "all undue or excess profits," Mr. Roosevelt had said:

> At the same time, while the number of individual Americans affected is small, discrepancies between low personal incomes and very high personal incomes should be lessened; and I therefore believe that in time of this grave national danger, when all excess income should go to win the war, no American citizen ought to have a net income, after he has paid his taxes, of more than $25,000 a year.

The press was shocked by this "C.I.O." proposal, as it was called. I told the committee that the President's recommendation would need implementation, and that I would present the Treasury's suggestions at the earliest possible moment after we had had time to study its administrative implications. One member told me to save myself

work; they were going to vote down the proposal immediately for good and all. But I was given time without any vote and the Treasury subsequently presented a memorandum to the Ways and Means Committee outlining a 100-percent war supertax upon individual incomes above $25,000. Under existing rates the supertax proposed would have affected only single persons whose incomes before tax exceeded about $40,000 and married couples whose combined income before tax approximated $110,000. Under the rates which had been tentatively adopted by the committee the corresponding figures were $50,000 and $185,000. With mandatory joint returns (which had been tentatively adopted by the committee) the tax would have fallen upon 11,000 single persons and married couples and would have yielded an additional $184,000,000.

Through the tepid Washington spring the executive session moved on to its dramatic last days. A combined normal tax and surtax rate of 40 percent had been adopted for corporations. Upon the committee's reversal of its stand in favor of joint returns a strong movement developed for eliminating the special privilege of splitting income enjoyed by the residents of community property states. The necessary votes were ready for the adoption of such a proposal when the members representing the community property states arranged a deal to vote in favor of a 45-percent corporate rate if those favoring that rate would vote against the community property proposal. Votes were taken in accordance with this arrangement, and the community property special privilege remained in the law. Later the committee introduced on the House floor an amendment reducing the corporate rate to 40 percent and increasing the excess-profits rate from 87½ percent to 90 percent. After a four-day debate the House voted the 45-percent corporate rate and it became a part of the House bill; at the same time it accepted the 90-percent excess-profits rate proposed by the committee.

In June, after three months of work, the Ways and Means Committee was still nearly $3,000,000,000 short of the additional revenue requested by the Treasury. Secretary Morgenthau went to the people by radio. After praising them for their previous sacrifices and saying they must make more, he concluded:

> The people have shown in thousands of ways that they are not in a mood for half measures, either financial or military. They

> will be critical only if the burdens are unfairly distributed. They will be disappointed in their leaders only if these leaders fail to ask them for all-out effort. . . . I hope it cannot be said of the new tax bill that it was too little and too late.

But this exhortation failed to produce anything more than anger in Congress. In the words of an Office of War Information spokesman, as a nation we were not yet more than "ankle deep in the war." To many inflation seemed far away. Military events were close and pressing. Taxes were a dull subject. In final desperation the committee scraped the bottom of the barrel and sent to a waiting House a bill providing for an additional $6,100,000,000 of revenue.

It was midsummer of our first year of war and our first war revenue bill had completed less than half of its journey through Congress. Now the country was spending $150,000,000 a day, or almost $5,000,000,000 a month. Nearly half of the national income was being spent for war. Even if the House bill became law, it would be necessary to borrow $53,000,000,000 in the fiscal year 1943. The proportion of expenditures being financed by taxes was distinctly below that of Great Britain and Canada. Prices continued to rise.

On the battlegrounds now girdling the globe the aggressors still held the initiative. Egypt and the Near East were in danger from Rommel. The Japanese seemed to be waiting for the most opportune moment to attack Siberia. In the West the greatest peril to the Allied cause lay in the Wehrmacht's continued advance toward the Caucasian oil wells and the strategic Volga waterway. Joseph Stalin called upon the Red Army for a desperate stand: "Not one step back! The execution of this task means the preservation of our country, the destruction of the hated enemy and a guarantee of victory." The next six weeks might prove to be the most crucial in all history.

Late in July the Senate Finance Committee commenced public hearings. Mr. Morgenthau renewed his plea for $8,700,000,000 of additional revenue which was "more emphatically" than last spring "the very least we could afford to provide today." Again he pleaded for the elimination of special privileges. The exemption of interest from state and municipal securities cost $200,000,000 a year under the House bill rates of tax, and one taxpayer would pay a tax of only $243,000 on an income of $975,000. Leading oil companies were still taking percentage

depletion on properties the cost of which had been fully recovered tax free; this amounted to another $200,000,000 annually. A family in which the husband earned a salary of $10,000 paid a tax of $1,788 if it lived in California, a community property state, and $2,152 if it lived in Iowa, a noncommunity property state. "Common decency," the Secretary thought, required the elimination of such discriminations at a time when we were "straining our energies to the utmost to defeat a powerful and ruthless foe."

The committee was unimpressed. Witnesses rushed to Washington to make their pleas. The committee listened to 250 persons whose reported testimony comprised 2,376 pages. They all wanted to win the war and believed in high taxes. But taxes should not crush free enterprise, prevent expansion, reduce production and jeopardize the war effort. The geese that laid the golden eggs should be carefully nurtured.

A month of executive sessions followed. It was highlighted by the sudden appearance of Mr. Morgenthau before the committee on September 3 with a recommendation that Congress enact a spending tax which, with the lowering of personal exemptions, would bring in $6,500,000,000 and make the total additional revenue requested by the Treasury $15,200,000,000. The committee now had before it the biggest, toughest tax program in history. The Secretary's recommendation was almost summarily rejected, first by a vote of 12 to 0, and later, after Senator LaFollette offered an amendment allowing a deduction for rent, by a vote of 8 to 4.

The spendings tax foundered on the rocks of administrative intricacy. There was the perennial dilemma. When a revenue proposal is presented in general terms, Congressmen want to know how it will be implemented. When the particulars of a proposal are immediately offered, the mass of detail makes it seem too complicated. The Treasury was impaled on the latter horn. Senator Byrd described the spendings tax proposal as "the most complicated and unworkable plan" the Treasury had submitted in nine years. To Senator Guffey the scheme was stillborn. It "staggered" Senator Johnson's imagination. Senator Davis threw up his hands: "It is too complicated for an ordinary man like me to understand." The committee proceeded to draft a bill along more conventional lines.

The Finance Committee continued its labors almost through September. Finally a bill was ready for the tumultuous Senate floor where

amendments are freely permitted. It raised approximately $500,000,000 more than the House measure. This, according to Senator George, the able Finance Committee chairman, represented "perhaps the maximum direct taxes which can be imposed during the war." The Senator admitted that "it does not go very far toward checking inflation." For that reason, he said, the committee provided for a joint committee to study compulsory saving and make recommendations to Congress by December 1.

Again the stalwart LaFollette had "individual" views. In the face of such astronomical budget requirements it was "absolutely imperative that tax revenues be increased in every way possible without impairing national health, morale and fighting efficiency." The bill failed to raise "a reasonable maximum of revenue which is available without undue sacrifice." It was possible, entirely within the ability-to-pay principle, to increase the revenue from individual surtaxes on the middle and upper income brackets. The bill placed "an unfair and dangerous share of the increased tax burden upon the lower income groups, encroaching upon subsistence standards of living and in effect taxing bread out of people's mouths." Since 1939 the aggregate net income of corporations reporting net income had increased 146 percent. Some of this increase had been taken back in the form of excess-profits taxes, but the Senator from Wisconsin was convinced that additional revenue was still available from this source. "When the nation is asking its soldiers to give up their normal civilian pursuits, break off family ties, and risk their lives . . . it is indeed a small request to make that a corporation simply relinquish the extra net income resulting from war production," he stated.

On Labor Day President Roosevelt had summoned Congress and the nation to an all-out attack on the inflationary peril that had been threatening the war effort since mid-1940. In his message the President had said that the seven-point anti-inflation program he proposed in April was endangered by the weak handling of three factors. On two—farm prices and taxes—he had urged Congress to speed up legislation. On the third—wages—he had promised to follow with an executive order. The long delay had now reached the point of danger to our whole economy. If Congress did not act, the President had warned that he would do so without new statutory directives. He had pointed out that the Federal Treasury was losing millions of dollars a day because a

tax measure had not yet been passed. Taxation was "the only practical way of preventing the incomes and profits of individuals and corporations from getting too high." The President had repeated his proposal for limiting individual incomes to a maximum of $25,000 a year after taxes and again had urged that corporate profits should not in any case exceed a reasonable amount. He had set October as the dead line for Congressional action.

On October 2, after more than three weeks of acrimonious debate involving not only farm prices and wages but also the issue of executive and legislative powers, Congress completed passage of an anti-inflation measure. On October 3, moving swiftly, the President issued a sweeping order to implement the new law. It directed the National War Labor Board to limit wages and salaries, the Office of Price Administration to fix ceilings on rents, and the Department of Agriculture and the OPA to co-operate in holding down farm prices. It also created an Office of Economic Stabilization with broad policy-making powers to control the nation's living costs. The order did nothing about reducing the large excess of purchasing power which hung menacingly over the national economy. That was a problem for taxation and war savings.

Final action on the 1942 revenue bill was imminent. On October 2 the measure reached the Senate and it was passed on October 10 without a dissenting vote. It contained 504 amendments. The conference committee followed with a five-day session in which the House receded on all but eighteen of the Senate amendments. On October 21, as United States troops stood poised for decisive action in the Battle of the Solomons, the President signed "the greatest tax bill in American history." In the home front battle of inflation we were beginning to emerge from the period of "phony war."

According to Treasury estimates, the Revenue Act of 1942 added about $7,000,000,000 to the tax system, which alone was more than was provided by the entire revenue system in any one year previous to 1941 and was nearly as much as the Federal budgets which caused such alarm in financial circles in the thirties. About $1,300,000,000 of this increase came from corporations; about $5,000,000,000 from individuals; the rest came from increased excises, the most important of which were liquor taxes, cigarette taxes and a new tax on the transportation of property to which the Office of Price Administration strenuously

objected on the ground that it would raise prices. Congress refused to accept Treasury recommendations for increased estate and gift taxes and a spendings tax, and it rejected Secretary Morgenthau's proposal that the capital stock tax and declared-value excess-profits tax be repealed. The bill was inadequate before it was passed; it would be necessary to borrow $60,000,000,000 for the fiscal year 1943.

In the official copy the Revenue Act of 1942 ran to 208 pages, as compared with 8 pages in the 1894 Act. It contained more relief provisions than any other revenue measure in American history. More than half of its total 208 pages, or 120 pages, was devoted to the relief of inequities. The principal loopholes of our revenue system were not closed, but several loopholes which for years had offered opportunities for avoiding taxes disappeared from the statute. The act devoted 42 pages to the clarification and definition of existing provisions to enable more equitable enforcement. This made 104 corrective sections out of a total of 173. In pages, this was nearly 78 percent of the act, 162 pages out of 208. In this sense, if not in a fiscal sense, the bill performed an outstanding service. We had reached the point in our rate structure where loopholes resulted in drastic loss of revenue, and where inequities and discrepancies threatened to be not only troublesome, but even disastrous, to taxpayers.

The income tax was now a mass tax. The Senate Finance Committee report on the 1941 Act noted an increase in the number of annual returns to over 22,000,000, of which over 13,000,000 would be taxable returns. This seemed a long jump from 2,000,000 taxable returns in 1932. But the 1942 Act carried the total number of returns to nearly 37,000,000 of which almost 28,000,000 would be taxable. There would be more than 50,000,000 taxpayers, including Victory taxpayers.

The increased individual income taxes in the 1942 Act came partly from the reduction of the personal exemption which Mr. Morgenthau had recommended with misgiving in May, partly from raising rates, and partly from imposing a Victory tax with an exemption of only $624 (52 weeks at $12 per week) beginning January 1, 1943. This tax, which was levied at a 5-percent gross rate less certain credits, was to be collected at the source. The top surtax rate was raised from 77 to 82 percent; with the 6-percent normal tax and 5-percent Victory tax the top rate went above 90 percent and a 90-percent limitation was inserted in the statute. The capital gain alternative tax rate was also

increased, but the required holding period was reduced to six months.

The Treasury opposed the introduction of the Victory tax on the grounds that it would unduly complicate the individual income tax and that the use of a low flat exemption for all taxpayers, regardless of family status, would result in an inequitable distribution of the tax burden. The postwar credit in effect reduced the rate at most income levels to 3.75 percent for single persons and to 3 percent for married persons, or less for those with dependents. As it worked out, the combined income and Victory tax of a married person with two dependents having a net income, before the personal exemption, of $2,700 was $254.60 with a postwar credit of $52.27. This made the net tax $202.33 and the effective rate of the net tax 7½ percent of net income.

Some individual relief provisions mitigated this additional burden. A limited deduction was allowed for medical expenses. Divorced husbands were relieved of tax upon alimony payments and the wives who received the payments were made taxable. Members of the armed forces below the rank of commissioned officers were given a special exclusion to offset the reduction in exemptions.

The Treasury's efforts to secure increases of corporate taxes were not so successful as its efforts to secure increases of individual taxes. The 45-percent combined corporate normal tax and surtax, voted in a stormy session on the House floor, was lost in conference, but the rate finally adopted for larger corporations was 9 points higher than before, rising from 31 percent to 40 percent. A notable accomplishment of the act was a revised and higher tax on life insurance companies to which the companies agreed in advance. Under previous acts they had paid a total of less than $1,000,000 a year; under the new provision they would pay approximately $27,500,000 a year.

In the corporate field the 1942 Act placed major revenue reliance upon the excess-profits tax. The graduated rates of the 1941 Act, which stopped at 60 percent, were raised to a flat 90 percent. For corporations other than railroads, consolidated returns for income tax purposes were permitted for the first time since 1934.

Congress was generous with relief provisions designed to ease the impact of the excess-profits tax. In determining its excess-profits credit a taxpayer might substitute for the lowest of the base-period years, 1936-1939, 75 percent of the average for the three other years. Previously a taxpayer could use zero for the largest deficit year of the

base period. More important was the retroactive provision for reconstruction of base-period earnings under Section 722 of the Internal Revenue Code. Its purpose was to ensure that average earnings adequately reflected normal profits. If specified unusual events in the base period depressed base-period income, that income might be reconstructed to eliminate this effect. If certain changes took place during the base period which had not been reflected in profits by 1939, base-period income might be redetermined to reflect those changes. Up to July 1, 1946, the Bureau of Internal Revenue received over 41,000 applications for relief from 18,000 corporations under this provision, involving refunds aggregating over $4,000,000,000. The Bureau has estimated that additional claims for 1943, 1944 and 1945 will raise this total to $8,000,000,000.

The excess-profits tax was not imposed upon all the income of the corporation. The income from which the excess-profits credit was subtracted in order to compute the income subject to tax was defined to exclude abnormal items or nonwar income. There were numerous examples of this treatment: for instance, the special treatment for mining and timber operations where output had exceeded output in the base period; the special treatment for taxpayers on an installment basis or operating under long-term contracts; the exclusion of capital gains and losses; and the exclusion of dividends. Moreover, certain exemptions were allowed in order to stimulate wartime output as, for example, the exemption of strategic minerals and the exemption of bonus payments by a government agency to certain producers of natural resources who exceeded their quotas.

The nominal 90-percent excess-profits tax rate on its face broke all records in the United States for the taxation of corporate profits. But several provisions softened this blow. The act contained an 80-percent limitation which placed a ceiling on the amount of taxable income that might be absorbed by the income and excess-profits taxes. It became effective when excess profits were approximately four times as large as the excess-profits credit, and could result in substantial tax saving. As soon as a taxpayer became subject to this limitation, the 90-percent excess-profits tax rate no longer applied to each additional dollar of income. Instead, additional income could be taxed only at an 80-percent rate.

It was estimated that this limitation would apply to about 6 percent

of all excess-profits taxpayers in 1944 owing approximately 40 percent of total excess-profits tax liabilities. For these taxpayers the tax reduction might be quite substantial. The limitation was the equivalent of doubling the excess-profits credit for taxpayers whose excess profits represented 90 percent of their total income.

A postwar refund of 10 percent of excess-profits taxes converted part of the excess-profits tax into a compulsory lending device. This refund was available in the form of bonds which would become negotiable after the cessation of hostilities. The refund for any one year might be taken currently up to 40 percent of net debt repayment. It therefore reduced the gross excess-profits tax rate of 90 percent to 81 percent; and, if the taxpayer were subject to the 80-percent limitation, it might reduce the net excess-profits tax rate to as little as 72 percent.

A provision for a two-year carry-back of unused excess-profits credits and net operating losses completed the picture of corporate tax relief. Under this provision all taxpayers might deduct net operating losses from income earned in the two years preceding the loss, and excess-profits taxpayers might reduce excess profits of the two preceding years by any deficiency of income below the excess-profits credit. These adjustments, in association with the carry-forward provisions inserted in 1941 as part of the excess-profits tax amendments, permitted the averaging of income over a five-year period. This, however, was not their major purpose. That purpose was rather to provide a general method of offsetting reconversion costs and losses against wartime income. Government thus became a partner in industry's reconversion costs and losses. The carry-backs were an indirect, and not a direct, adjustment. Reconversion costs and losses would reduce postwar income. If they reduced it to a point below the excess-profits credit, or turned it into a loss, the carry-backs came into operation and wartime income would be readjusted. Wartime tax liabilities were thus to be redetermined in the light of subsequent events.

The 1942 Act made several important estate and gift tax changes. The special life insurance $40,000 exclusion was dropped; the former specific exemption of $40,000 was raised to $60,000; and other important changes were made in the life insurance provision. The power of appointment provision was extensively revised. Community property, formerly to be divided between husband and wife in accordance with state law, lost this special status and was required to be treated

like jointly owned property. The gift tax specific exemption of $40,000 was reduced to $30,000, and the $4,000 annual exclusion to $3,000.

The 1942 Revenue Act was distinguished for what it did not do, as well as for what it did. It is remarkable that the temptation to resort to sales taxation, urged by many powerful interests, was resisted. The pressure for the tax was strong in both Houses. Representatives Disney and Robertson led the fight for the tax in the Ways and Means Committee, and Senators Vandenberg and Byrd in the Senate Finance Committee. In the latter committee the vote was uncomfortably close, and the verdict might have been different if the Victory tax had not been adopted.

The Treasury opposed the sales tax from the beginning, and was roundly criticized for its stand. It objected to the tax first on the ground that it was a manifestly unfair way of distributing the cost of the war. Secretary Morgenthau told the Ways and Means Committee:

> The general sales tax falls on scarce and plentiful commodities alike. It strikes at necessaries and luxuries alike. As compared with taxes proposed in this program, it bears disproportionately on the low income groups whose incomes are almost wholly spent on consumer goods. It is, therefore, regressive and encroaches harmfully upon the standard of living.

There were at least three places in the economic chain where a sales tax could have been levied: on manufacturers, on wholesalers or on all retail sales. The task of administration would have varied enormously according to which of these taxes was adopted. The tax on manufacturers would probably have been the easiest to administer and enforce. It would have been directly paid by 157,000 manufacturing taxpayers. A tax on sales by wholesalers would have differed little from the administrative point of view. It would have been paid by some 306,000 taxpayers. Either of these taxes could have been administered by a relatively small force.

But the dilemma was that either of these taxes would have played havoc with our whole price-control system. A tax at these early stages in the production-distribution process would be treated as an ordinary cost of doing business. This would lead to the necessity of determining how the tax affected the cost of each particular product, or of examining every situation to see whether the seller could absorb the price

increase and, if not, of granting increases above the ceiling prices. Each increase would necessitate still further increases at subsequent stages in the productive and distributive process. The difficulty of preventing the maintenance of percentage margins might lead to increases greater than the tax imposed. It was small wonder that Mr. Henderson "shuddered" at the thought of how the Office of Price Administration would be swamped if such a tax were enacted.

The retail sales tax to some extent would get by this Scylla only to run into Charybdis. While it would affect price ceilings, it would not demolish them. But its administration would be very difficult when the nation's man power was being marshaled for war. There were over 2,500,000 business units selling at retail. A tax on retail sales would require frequent tax returns from every one of these taxpayers. It would require a huge administrative force. A large, well-trained field staff to audit the taxpayers' books periodically is the backbone of an efficiently administered retail sales tax. The recruiting of personnel would have been extremely difficult when there was such a great demand for man power by the armed forces and war industries. In addition, it was possible that the equipment needed, such as accounting and business machines, typewriters and transportation equipment for a field staff would be difficult to obtain.

The sales tax advocates were romantics about the amount of revenue the tax would yield. The fact was that the base for a sales tax on tangible goods in 1942 would probably have been little more than $50,000,000,000; the rest of the $80,000,000,000 total of consumers' goods and services represented services which could not be readily subjected to a sales tax. The minute exemptions were granted, the $50,000,000,000 base would be dissipated. It would be reduced to $30,000,000,000 if food were exempted. To put the matter another way, in order to raise only $5,000,000,000, a sales tax of 11 percent would have been required if food were included in the base, and 17 percent if the regressive character of the tax were mitigated by exempting food.

Much of the support given the sales tax stemmed from the mistaken belief that foreign countries had found the tax an indispensable and primary weapon of war taxation. Actually, most countries, just as our own states, introduced the sales tax not in time of war but at a time when other revenue measures became unproductive. They adopted it in depressions when the income base shrank and in periods of hyper-

inflation when income taxes assessed one day became meaningless the next. In Canada, Great Britain and Australia the relative importance of sales taxes had declined as the war progressed.

The sales tax was too crude an instrument to do an effective job in controlling inflation. It was insensitive to differences in spending capacity. Every person would pay the same tax rate whether he contributed $1 or $1,000,000 to the stream of inflationary spending power. Thus the tax failed to discriminate between persons who could reduce their purchases substantially and persons who could not do so. In consequence, it was impossible to impose a sales tax at sufficiently high rates to curtail the consumption of persons whose living standards were liberal, without at the same time placing an intolerable burden on tens of millions of citizens. If it were imposed at low rates, the sales tax would exercise little or no restraining influence on the people who were in the best position to reduce their standards of living.

While the Congressional tax committees were casting about for ways and means to raise the vast sums of revenue requested by the Treasury, some sentiment developed for an individual excess-profits tax. Such a supplement to the income tax had a special appeal in time of war, because many individuals were enjoying increases of income as a direct result of the war, and also because individual proprietorships and partnerships were exempt from the excess-profits tax.

Upon close examination, however, a tax on increases in individual income had serious shortcomings. A large part of the increase in national income represented higher wages earned by those in the lower income groups. In many cases these higher wages resulted from steadier employment, more hours of work, extra pay for overtime and bonuses for extra output. The combination of a special tax on increases in individual income and increases in the regular income tax, when a great number of workers were being called upon for the first time to pay income taxes, might have seriously deterred many people from putting forth the maximum war effort. Workers in overcrowded war-industry cities might quit and go back to peacetime pursuits. Women might be discouraged from taking jobs.

Then, too, a special tax on the excess of current income over income in a specified base period would have discriminated against certain groups of taxpayers. The most conspicuous case, perhaps, was the person whose income was abnormally low in the base period, or who was

unemployed and was entirely without income in the base period. It would be difficult to explain why one of two individuals, both receiving $2,000 income, had to pay more tax than the other. No doubt the person who had no income in the base period had less current taxpaying ability than the one who had earned $2,000 continuously over the past few years. Presumably the man with a steady income, who had been able to keep himself and his property in good repair, was at least as well able to bear the war burden as the worker who was employed for the first time in years.

A tax on increases in individual income would have been especially burdensome to a member of a family who had become a wage earner to compensate for the loss of earnings of another member of the family who had become unemployable, or who had been called to military service. Where a son or husband had entered the armed forces, the family income was likely to be reduced, even though the wife or another member of the family received a larger income currently than in the base period. In all probability, under a special tax on increases in income, inequity in this kind of case could not be avoided; the indications were toward millions of these cases.

A supertax of this type would also have impinged on normal increases in income in no way connected with war profits. The modest increase in the salary of a postman, fireman or a college professor, in accordance with an established promotion schedule, was an illustration. The tax would have been disastrous for those who were just establishing themselves professionally as, for example, an engineer who, after years of study and training, had finally secured a post. The craftsman who, as a result of the war, was for the first time given an opportunity at work of greater responsibility and skill within his competence, was another illustration of hardship cases which would arise under the proposed supertax.

The administrative problems involved in ascertaining what individuals were liable for this tax, and in determining the amount of their tax liability, would have been extremely complex. For the great mass of taxpayers no means would have been available for checking the income of the normal base period. Income tax records would have been available for only a relatively small number, because until recently high exemptions had excluded most people from the requirement of reporting. Also, many people with no intention of evading

taxes simply would not have had accurate information about their income in past years.

A tax of this type would doubtless have had to include extensive relief provisions to safeguard individuals with abnormalities in base-period income, or with extraordinary income in the current year, particularly where income was derived from small proprietorships and partnerships. Experience with analogous problems in the corporate field pointed to further administrative difficulties in this direction.

These considerations, together with the fact that any practicable scheme would have yielded little revenue and would have contributed even less to the control of inflation, led the tax committees to drop the subject.

Chapter 13

CURRENT TAX PAYMENT

1943

FOR the Western Allies 1943 promised to be a year of growing sacrifices. It would certainly be a year of growing hope. The Axis tide might have a long ebbing, but it had turned. In January Marshal von Paulus' German Sixth Army was still holding a precarious position in front of Stalingrad. In February the Russian trap closed and Germany suffered its greatest blow of the year on the scorched steppes of Russia. The Russians had bought back their soil with their own sweat and blood. In Tunisia the British and American armies which had invaded North Africa in a huge armada of assault boats in November 1942 would soon crush the veteran desert armies of Field Marshal Rommel. Nazi dreams of African empire would lie buried in German graves that stretched from El Rlamein to Cape Bon. Before the year's end Sicily would be conquered in thirty days of lightning warfare, southern Italy would fall, and the Allies would be driving toward Rome, the capital of a new Italy cleansed of Mussolini and his Fascist system after twenty-one years of corrupt power.

In 1943 would come the real test of American productive genius. The term "arsenal of democracy" would assume a new and grimmer meaning. The United States had increased its output of military items 250 percent during 1942, but even that amazing record was only a curtain raiser for 1943. Admittedly airplane and tank production had fallen numerically short of the goals set in 1942. In some cases the experience of the battlefield had forced changes, but there was still plenty of reason to be proud of the record.

In January President Roosevelt found the state of the nation "good," the heart of the nation "sound," the spirit of the nation "strong" and

the faith of the nation "eternal." In his message on the State of the Union he reported with "genuine pride" on what was accomplished in 1942.

> We produced about 48,000 military planes—more than the airplane production of Germany, Italy and Japan put together. . . .
> We produced 56,000 combat vehicles, such as tanks and self-propelled artillery. . . .
> We produced 670,000 machine guns, six times greater than our production in 1941. . . .
> We produced 21,000 antitank guns, six times greater than our 1941 production. . . .

The President had good reason to think that the arsenal of democracy was "making good."

In January also the President presented his astronomical second war budget. This budget was not held to earth by any question of what the nation could financially afford. It was designed to reach the limit of what the country could manage, by straining night and day, to spend on the war. For the fiscal year 1944 Mr. Roosevelt estimated that the United States could spend over $104,000,000,000; this was more than the budget of any other nation in any year in all history. It reflected, he said, the determination of American civilians "to pass the ammunition."

In January the government was spending at an average of $6,000,000,000 a month for military requirements; that average would reach nearly $8,000,000,000 during the fiscal year 1944. In 1943 the people, working harder than ever before, would pocket $142,000,000,000. But most of their labor would go off to war. For every $15 they had to spend there would be only $10 of civilian goods available. American citizens now had about $45,000,000,000 of income in excess of available goods—more than the entire national income in 1932. The world had never known such figures. They were too huge to carry any concrete meaning. They were abstractions that could be compared only with other abstractions.

The simple routine of daily living became more complex and difficult; it was evident in the vanishing stock on store shelves. Bidding for scarce goods forced prices to higher levels. Price increases brought demands for higher wages. Business groups continued their implacable struggle against the OPA. Black markets were in operation in many

commodities, selling goods above ceiling prices and ignoring rationing restrictions. Disorder had insinuated itself into the national scene.

In April the President invoked his war powers to halt the nation's progress up the spiral road to inflation. He issued the "hold-the-line" order by which all items affecting the cost of living were to be brought under control. The order said, in effect, that future price increases should be restricted to the minimum extent required by law and some cost of living commodities which were above the level of September 15, 1942, should be reduced in price. There were to be no further increases in wage rates or salaries beyond the "Little Steel" formula, except where clearly necessary to correct substandards of living. One of the most important provisions directed the War Manpower Commission to forbid workers to change their employment unless authorized by the commission to do so. In an accompanying statement the President said we must also be prepared to "tax ourselves more, to spend less and save more."

In March of 1942 Mr. Beardsley Ruml, Treasurer of R. H. Macy & Company, Inc., New York City, and Chairman of the Federal Reserve Board of New York, had published a pamphlet in which he advocated changing the measure of tax to be paid in 1942 from 1941 income to 1942 income. In July he had appeared before the Senate Finance Committee to present what he called the "Pay-as-you-go Income Tax Plan." The plan aroused little immediate interest. But the press was articulate and the Chairman of the Senate Finance Committee appointed a subcommittee consisting of Senators Clark, Danaher and Gerry to report to the full committee on the plan. This subcommittee listened further to Mr. Ruml and approved his plan unanimously. But thirteen members of the full committee could not agree and Mr. Ruml's scheme went into eclipse.

Mr. Ruml was discouraged but not defeated. His plan had political appeal. Though he conceived it as a method of getting people out of debt to the government, the public thought Mr. Ruml had found a very white rabbit which would somehow lighten their tax load. In the hearings before the Senate subcommittee in August, Mr. Ruml was easily persuaded to be more expansive than he had previously been before the full committee. Senator Clark asked everybody to "move in a little closer" and the tactful Mr. Ruml appreciated the opportunity of "unburdening" himself "a little further." The awkwardness of pro-

viding for the retirement of people who had grown old in service and who would be "perfectly prepared" to retire on a "modest income of $5, 7 or 8,000" had occurred to Mr. Ruml and his friends about a year previously. It was "necessary" to provide these retiring executives "first with the income tax, and that became income, and income tax on that income, and it got into a situation that made it impossible for a corporation to get into that sort of thing generally."

The war had stimulated Mr. Ruml's vision. After it "broke out" he "saw another thing." Macy's department store had a "young man in the Comptroller's office who was making $75 or $100 called into the Navy at a salary of $2,600 and we had to get together and take care of his income tax for him." That was "another impossible situation." Moreover, some of Mr. Ruml's many friends had come to Washington to work in the government; their alternative was either to "come on a dollar-a-year sort of thing, which is very objectionable, maintaining their corporate salary, or come against the old income tax debt problem." Mr. Ruml was moved to generalize. We were all "in hock to the government for the same income tax debt, and it was a pernicious fungus permeating the structure of things." What would happen "in case we just started continuing paying our income tax, but on this year instead of on last year, and as we began to talk about what would happen we discovered that nothing would happen. It would happen some time during the generation, to be sure, but as far as the Treasury and income were concerned, things would move along just the same as time moves on under daylight saving, so as we analyzed it, it seemed clear that great benefits would come, that there would be no substantial economic consequences except spread out over such a long period that it could be taken care of in some other form, and it would serve a real public purpose."

This reasoning came as no surprise to the Treasury representatives present at the hearing. Mr. Ruml had discussed the matter with them in the spring and early summer at occasional luncheons at the Treasury, which he facetiously described in intimate circles as "fish dinners." Macy's treasurer was a steak man himself. The Treasury representatives advised Mr. Ruml to present his ideas to the Senate Finance Committee; it was too late to go to the Ways and Means Committee. There was great sympathy in the Treasury with Mr. Ruml's basic purpose, but to some of us it seemed that Mr. Ruml had oversimplified a difficult

problem. His plan did not then include any provision for collection of the tax at the source, which seemed the easiest way to put taxpayers on a current basis. Without collection-at-the-source Mr. Ruml's plan would accomplish his objective of keeping the taxpayer out of debt, but for persons with fluctuating incomes the plan would make the payment problem worse rather than better. It would also seriously complicate the computation of tax where rates, exemptions and the definition of taxable income changed, as they frequently did, from year to year. Perhaps most important of all, the plan shifted the tax burden from present taxpayers to new taxpayers and would result in a windfall gain to persons whose incomes were abnormally high in 1941—a particularly undesirable result because abnormally high 1941 income derived in many cases from the war effort.

This whole problem of current payment had been under consideration in the Treasury for a long time. In response to the increasingly inflationary threat of price rises, Secretary Morgenthau, in November of 1941, had informally presented to the Ways and Means Committee a plan for collecting at the source the major portion of new taxes to be imposed. But the committee had turned a deaf ear. In his statement of March 3, 1942, before the Ways and Means Committee, the Secretary had suggested that the "best available expedient" to achieve a more convenient method for the payment of income taxes was a "provision for collecting at the source for those incomes that are paid periodically, including wages, salaries, bond interest and dividends." On May 20 and again on June 19 against the embarrassing protest of the Commissioner of Internal Revenue, Treasury representatives presented extensive arguments to the Ways and Means Committee urging a system of collection at the source as necessary to "the very existence of the income tax."

Commissioner Helvering's testimony on the administrative problems of current collection had been a dash of very cold water. To collect the tax he estimated that the Bureau of Internal Revenue would need somewhere between 9,000 and 12,000 additional employees and this at a time, he said, when they were unable to maintain satisfactorily their present authorized force. He anticipated "much difficulty" in securing the required office space, equipment and supplies. It would require at least three months after final enactment before operations could commence, and the appropriations for the first full year would

"approximate $24,000,000." Some understanding, the Commissioner emphasized, must be had from a priority standpoint as to personnel, equipment, supplies and funds, if the proposed law were to be administered satisfactorily.

Later, in August, Mr. Helvering told the subcommittee of the Senate Finance Committee that the equipment situation and the prospect of securing adequate space had grown "worse from the Bureau's viewpoint" than it had been when he appeared before the Ways and Means Committee. Despite the fact that the Bureau had been given a priority status on personnel, the personnel situation "could not be said to have improved." The Bureau looked with great concern upon its inability to recruit 5,400 employees needed to carry the regular work load, and 11,000 more would be required to administer the withholding plan. Furthermore, these employees must be "qualified in certain essential functions"; you couldn't take a "spit in the gutter" fellow and put him in the Internal Revenue Service. It had taken until 1938 to "clear up" the records from World War I and it would be "unfortunate" if by reason of the enactment of a withholding tax a similar condition recurred now. Mr. Helvering suddenly developed sympathy for harassed businessmen. It was possible that a number of financial and industrial organizations "would be even more seriously embarrassed" by the withholding plan than the Bureau would be. The Commissioner "couldn't help but think that, while you gentlemen are scratching your heads to find additional items of taxation, the effect will be to force upon industry the payment of large sums for the administrative cost of the withholding tax." Since these items would become deductions for business expense, the Commissioner hastened to point out that the result would be "considerably reduced taxes from these companies."

It would be a masterpiece of understatement to say that these pronouncements, never submitted to the Treasury, were extremely embarrassing. I had to reply off the cuff. I tried to take some of the curse from the Commissioner's testimony by emphasizing the advantages of collection-at-the-source in making tax payments easier, in strengthening the government in its critical fight against inflation by withdrawing purchasing power from the spending stream before it could exert an upward pressure on prices, and in guaranteeing a more prompt and certain flow of revenue to the Treasury than the existing method of collection did. I went on to explain the systems of Canada, Great

Britain and Australia and, despite Mr. Helvering's wet blanket, the committee was well disposed toward the withholding idea. But the problem of transition was hard to hurdle. In the first year, 1943, some taxpayers would be required to pay, at the same time, the tax on 1942 income and part of the tax on 1943 income. The Ways and Means Committee proposed to get over the hump by a gradual transition. As the oratorical fireworks in the halls of Congress subsequently proved, this solution was easier proposed than disposed. Later, collection-at-the-source was applied to the Victory tax developed by the Senate Finance Committee.

Mr. Ruml was a good general. He shifted his strategy and amended his plan. Before the Senate committee he testified that it offered advantages in instituting collection-at-the-source and that current collection could be incorporated into his plan. The Treasury agreed that collection-at-the-source would greatly improve the Ruml plan because tax payments could be synchronized with income payments. It acknowledged that the plan deserved "serious consideration," if linked with collection-at-the-source at a rate equal to the combined normal tax and first bracket surtax rate. The Treasury went on to suggest other modifications to mitigate remaining defects; at one point in the Senate committee executive session the Treasury suggested a plan, very similar to the Robertson-Forand plan later adopted by the House, which would have made about 90 percent of taxpayers current except for minor year-end adjustments. From this point on violent controversy developed within Congress over these remaining aspects of the plan.

The controversy within Congress was preceded by a deluge of publicity. Representative Disney later commented that Mr. Ruml had a "bigger following than Dr. Townsend had in 1934 and 1935." Among Mr. Ruml's most vituperative adherents was Louis Bromfield, who wrote an eloquent, if inaccurate, letter published in the *Washington Post* on November 20. Speaking, he said, for "the American taxpayer," the author voiced growing concern about the ability of taxpayers to meet increased taxes on March 15; he went on to charge the Treasury with failure to take adequate steps to help the people out of their difficulties. Mr. Bromfield had not bothered to consult the latest statistics on individual savings. A fourth to a third of the population, he predicted, would not be able to pay up because "there is no money." Mr. Morgenthau's "suggestion of paying two years' income tax out of

one year's income"—a suggestion never made by Mr. Morgenthau—displayed "an amazing ignorance of the facts of economic life as they affect three-fourths of the population of the United States." Blazing phrases fell from his pen. The citizens of the United States had "a right to know where they stand." No single element was "so destructive to national morale" as the tax situation at the present moment, under which taxpayers were "perpetually in a state of financial horror." Half the population of the United States—the entire middle class—Mr. Bromfield charged, was faced with the prospect of severely diminished income for 1943 and succeeding years. His own words were intoxicating to a defeatist. The present system of taxation could end only "in economic confusion and infinite human misery and discontent." It was not possible to draw money out of "the economic vacuum" toward which we were headed.

Such irresponsible talk from a person the public might expect to know better elicited a reply from me which was published on December 8 in the *Washington Post*. I pointed to the record. It showed that the Treasury had been in the forefront in its efforts to bring about a more realistic attitude toward meeting our increasing need for war revenue. Since 1941 we had repeatedly urged that the income tax be placed on a current basis in order to accomplish two primary objectives: (1) to adapt the income tax to the weekly and monthly budgets of the millions of wage earners and other income recipients who were not accustomed to yearly budgeting, and (2) to convert the income tax into an effective and flexible instrument for the control of inflation.

The Treasury, I continued, agreed with the objective of the Ruml plan, putting taxpayers on a current, or "pay-as-you-go," basis. The sound and equitable method of "paying-as-you-go," however, was not the Ruml plan, but collection of the individual income tax at the source. Treasury opposition to the original Ruml plan was based on several reasons. The plan did not, in fact, put taxpayers on a current basis; it merely changed labels on the income tax payments they were making. By canceling a year's tax liability it gave a windfall to persons whose incomes were abnormally high in that year. There were also numerous administrative difficulties.

Moreover, both the psychology and the fact of cancellation of tax liabilities would be inflationary. Reserves that had been set up in advance for payment of taxes would be freed for expenditure, and people

would not have the repressive influence on their spending of a large impending tax liability. In the midst of total war it was hardly a wise policy to encourage, rather than to discourage, spending.

Mr. Ruml's recent modifications had not sufficiently eliminated the shortcomings of his proposal. Collection-at-the-source was desirable, but its cost need not be a windfall to some taxpayers and the transfer of billions of dollars of tax burden from one group of citizens to another.

Contrary to Mr. Bromfield's assertion that we had suggested paying two years' income tax out of one year's income, the Treasury had been fully aware of the problem of "doubling up" involved in the introduction of collection-at-the-source. It had suggested several solutions. In its recommendations to the Ways and Means Committee, the Treasury had proposed a gradual transition to current collection. The committee adopted a plan providing for withholding at a 5-percent rate in 1943, and 10 percent thereafter. When the urgency of current collection became even more apparent during the summer of 1942 and when the Victory tax was under consideration, the Treasury recommended inauguration of collection-at-the-source on January 1, 1943, at a rate of 15 percent of net taxable income; doubling up was to be avoided by scaling down the rates on 1942 income by 10 percentage points and raising the rates on 1943 income by 5 percentage points.

The difficulty of paying increased taxes which concerned Mr. Bromfield was a symptom of a more basic problem—adjusting our standard of living to the reduced supply of goods remaining for civilian consumption after war needs were met. When we were devoting substantially half of our man power and natural resources to war, we could not expect civilian goods to grow where war goods were planted. The economic burden of the war could not fairly be blamed on taxes. Taxation was not a cause, but rather a method. It was the method of distributing the cost of maintaining civilization.

Most of the Republican members of the Ways and Means Committee demanded in January 1943 that the pay-as-you-go issue be made the first order of Congressional business. The problem had become critical because many taxpayers had come to believe that they would have no taxes to pay in March. On January 15 Senator George and Mr. Doughton issued a statement warning all taxpayers that plans for Congressional action on a pay-as-you-go plan would in no way affect

their obligations to file an income tax return by March 15 and pay "at least" the first quarterly installment of tax against 1942 income.

Speculative and contradictory stories appeared in the press about the Treasury's attitude toward pay-as-you-go legislation. Silence had become less than golden. On January 23 I made a public statement that the Treasury favored early legislation to put income tax payments on a current basis. It was ready to respond at any time to an invitation by the Ways and Means Committee to present its views or give its advice. Many advantages would accrue from disposal of the pay-as-you-go matter as soon as possible. One advantage would be to refute most effectively the baseless rumors that some form of tax forgiveness would be adopted which would make it unnecessary for taxpayers to meet their March 15 installments on 1942 tax liabilities.

In his Budget Message of January 6, 1943, President Roosevelt had emphasized the necessity of putting income taxes on a pay-as-you-go basis. A period of day and night conferences followed between Mr. Doughton, Mr. Cooper, Mr. Disney and Mr. Robertson, and members of the Treasury staff and the staff of the Joint Committee on Internal Revenue Taxation. The situation was out of hand. It was finally decided to hold public hearings on a bill directed solely to the objective of putting the tax system on a current basis and to postpone the regular tax bill, which would be necessary to raise the $16,000,000,000 requested by the President.

Hearings before the Ways and Means Committee commenced on February 2, 1943. Two days before, three people stopped Representative Cooper in the lobby of the Washington Hotel and said they understood that they would not have to file any tax return on March 15, if the Ruml plan were adopted. Mr. Sullivan, Assistant Secretary of the Treasury, who was in charge of the Bureau of Internal Revenue, told the committee of the Treasury's concern at the "misapprehension in the minds of many taxpayers who have a feeling that perhaps something will be done by the Congress which will relieve them of the necessity of filing their returns and paying their quarterly tax." Reports from collectors indicated a sharp decrease in return filing. Mr. Sullivan asked the committee to take action

> today that would notify the American taxpayers that without any prejudice to any plan that is being considered by this committee,

or may be considered by this committee, they must file their returns and pay their quarterly installments. I think you will be doing the taxpayers a real service by such action.

I stated the Treasury position on the basic issue. I reminded the committee that in his Budget Message the President had asked Congress for "not less than $16,000,000,000 of additional funds by taxation, savings or both." The disposition made of the pay-as-you-go issue would have a direct bearing on the over-all revenue program. The existing income tax payment system was poorly adapted to the budgets and flow of income of 44,000,000 taxpayers. The lag in payments had become a serious problem with the war expansion of the income tax, the backbone of the Federal tax system. Again the Treasury recommendation was a system of collection-at-the-source for 30,000,000 wage and salary earners whose incomes after exemptions and credits did not go above the first surtax bracket of $2,000; a system of quarterly statements, or declarations of estimated income, and tentative payments, for 10,000,000 taxpayers whose incomes did not go above this bracket, but who received more than a nominal amount from sources other than wages and salaries; and a combination of these methods for the 4,000,000 taxpayers whose incomes exceeded the first surtax bracket.

On the problem of transition, I admitted frankly that in a period of rising national income the forgiveness of a year's liability would not reduce the cash flow into the Treasury. But complete "forgiveness" of 1942 liability was a horse of a different color. It would benefit persons with large incomes relatively more than persons with low incomes. For the individual with an income of $1,000,000 the forgiven tax represented almost 600 percent of a year's income after taxes. The forgiveness of a year's taxes would enable him to add to his wealth at one stroke as much as he could add in nearly six years by saving every dollar he had left after paying taxes and spending nothing, and as much as he could add in twelve years by saving half of what he had left after paying taxes. This economic windfall would not be offset by eventual increased taxes upon the estate of the forgiven person. Very great increases in governmental revenue were going to be required. It seemed more equitable to collect at least to a substantial degree the tax liabilities which had been imposed by past legislation than to forgive a year's liability and to raise the additional revenue by increases in rates, the

burden of which would have to be imposed more heavily upon the low and middle income groups, since it was only at this level that the income tax was capable of further expansion. A canceled liability could not be recouped from the high bracket taxpayers where rates were as high as they could go, but only in the lower brackets where rates could still be raised. I admitted that a simultaneous collection of 1942 and 1943 taxes would be too great a hardship and suggested methods for easing this problem.

After an endorsement of his plan by the New York State Bar Association, Mr. Ruml testified before the Ways and Means Committee on February 4, 1943. He now favored revision of his plan to omit 1942 taxes. He had only "glanced through" the Treasury statement of February 2, and his testimony was substantially the same as the testimony he had given the year before to the Senate Finance Committee. But he had developed some new and powerful phrases. His "reform" had developed "personal and humane" grounds. Income tax debt had become a "modern form of peonage" that locked men and women into their present work and level of income. The answer to a complex problem had become "as simple as daylight saving." Confusion had been caused by the term "forgiveness"; there was so much feeling about the word; it would be better—Mr. Ruml did not mention semantics—if his plan were thought of as "a change in the method of assessment, as the turning of the tax clock ahead, not as the stopping of the clock."

Mr. Ruml cited three points of difference with the Treasury. The first, "a point of fact"—a difference as great as that between night and day—was whether the financial well-being of the government would be injured by a loss of "assets" of $10,000,000,000 when revenues would be larger. If we accepted a rising national income as axiomatic, the Treasury, Mr. Ruml declared, would collect more dollars under his system than under the existing system in the twenty-year period January 1, 1943, to December 31, 1962, a fact the Treasury never denied, since it was not making this comparison. The answer to the "paradox" was to be found by examining the position of the Treasury on Judgment Day when the books would finally be closed. "Under our present system," Mr. Ruml asserted,

> the Treasury would have billions owing from the taxpayers. These would be bad debts in any case. Since the government is not con-

cerned about any final loss on Judgment Day, the government is able to turn the tax clock ahead, make all taxpayers current, eliminate income tax debt, and do it with increased revenue and with no additional burden on any taxpayer.

Mr. Ruml nailed down his argument by saying that he had submitted it to a group of members of the American Institute of Accountants who agreed that he was right. This logic elicited a blast from Nathan Robertson, well-known Washington correspondent, who wrote:

> Beardsley Ruml is arguing that the Treasury won't lose anything in the long run through canceling the taxes due on 1942 income, because, when Judgment Day arrives, the Treasury won't care whether any taxes are due or not.
>
> You ought to try that one on your landlord. It's very simple. Just tell him you will cancel that month's rent you owe, but you will pay him regularly every month from now on, and, when Judgment Day comes, he won't care whether you owe him for that other month.
>
> If your landlord hesitates, tell him you can get the American Institute of Accountants to prove it won't cost him anything.

So far Mr. Ruml and the Treasury had talked past each other. The second point of difference was one of "principle," involving the question whether there should be "equal treatment for all alike in every bracket." Mr. Ruml thought equal treatment meant cancellation for all taxpayers of complete liability even though the larger the amount of tax cancelled, the greater would be the benefit. The elimination of windfalls—which the witness disliked—could, however, be reconciled with equal treatment, and Mr. Ruml suggested three methods for achieving this objective: (1) no cancellation of the tax on capital gains; (2) a special death tax to recover windfalls; and (3) an averaging device to get fair normal income for forgiveness purposes.

Mr. Ruml regarded the third point of difference with the Treasury as one of "policy." Was it wise policy to "carry forward to the future the 1942 tax liabilities for a part of the taxpayers," or, to put the question another way, was it wise policy to "use the assessments on 1942 personal income as a basis for collecting revenue in the few years ahead, revenue over and above the assessments on current personal income for current income tax, and limited in application to some 4,000,000 taxpayers

whose incomes fall above the normal and first surtax bracket?" The witness thought such a policy "proposed," as he asserted, "by the Treasury" unwise. Mr. Ruml continued to address himself to a policy which had never been expressed by the Treasury. He had four reasons for his own contrary view. First, the so-called Treasury policy was opposed to the "right principle" of equal treatment; "wise policy cannot be founded on wrong principles; the result is sure to be uncertainty, disunity, conflict and lack of faith in the good faith of government." Second, as he erroneously understood it, the Treasury policy also violated "the principle of taxation according to ability to pay." It measured future year payments in terms of 1942 income. "The carry-over of the so-called liabilities for 1942 is only a polite way of increasing indirectly the assessments in future years on income taxpayers. What the method gains in politeness, it loses in crude inexactness and unequal burden in relation to ability to pay." Third, the policy he attributed to the Treasury would "impose an intolerable burden of double taxation." Finally, it would leave a large number of taxpayers with a large income tax debt outstanding, a debt they "would feel had been levied on a discriminatory basis." They would "persistently seek to redress" a "just grievance"; and an unwholesome factor would be introduced into American life. Mr. Ruml closed with a plea for collection-at-the-source. It had not been a part of his original plan.

Talk of this kind was too much for Chairman Doughton. He thought in simpler terms. He had an old-fashioned philosophy that one ought to pay his taxes "just as a man ought to pay his debts to his merchant"; he personally would not "feel happy" if he asked his creditor to forgive a debt he could pay. There was something shocking about a request from a good businessman for cancellation of the taxes of people who were able to pay "at a time when the government is having to impose the highest tax in its history" and "to borrow more money than at any other time in our history." Mr. Ruml had to admit that the government would have more revenue if it collected 1943 taxes currently and then collected all of the 1942 tax that the taxpayers were able to pay than it would under his plan.

The chairman yielded to other members of the committee. It was "revolting" to Mr. Disney's sense of honor "to walk out and leave the 1942 tax bill unpaid," and he was under the correct impression that "there is lots of money in this country." Mr. Cooper forced an un-

willing admission from Mr. Ruml that the taxpayer would "gain" from forgiveness, at least "at the time his income ceases or declines"—the higher the income tax bracket, the more his "relief" would be. The witness confessed to Mr. Gearhart that there would be "a year of income" under his plan "upon which the people would pay no taxes." Mr. Gearhart was troubled; "to walk off and leave a tax on $115,000,000,000" was to him "a very considerable amount to forgive" when people had "more money, more savings, with more weekly wages than they have ever had before in the history of the nation." Mr. Ruml agreed with Mr. McGranery's "simple matter of mathematics" that his plan would increase and implement "the principal account" of a taxpayer with a 1942 income of $1,000,000 to the tune of $854,000.

Republican members of the committee were more kindly. They complimented the witness on his statement and his contribution. The soft-spoken Mr. Carlson brought out Mr. Ruml's friendliness to the administration. Other witnesses testified that the plan was supported by such organizations as the American Institute of Accountants, the National Retail Dry Goods Association, the American Retail Federation, the American Legion, the National City Bank of New York, the New York City Bar Association and the New York State Bar Association.

Two weeks of public hearings and a month-long executive session followed. Then Mr. Doughton introduced his committee's bill in the House on March 17 with a majority report which stressed the inequity and unworkability of Mr. Ruml's plan, now embodied in the Ruml-Carlson bill. The committee bill provided for withholding of taxes from wages and salaries and crediting the amounts withheld on prior-year liabilities by applying those amounts to current liabilities. It also permitted taxpayers to put themselves voluntarily on a current basis by paying an estimated tax at a discount. The majority believed that most of the American people would not want any of their taxes forgiven. "This is a debt which has already accrued and in equity and good conscience must be paid ahead of any other liability that may occur for future years." "Compelling reasons" had led the majority to discard the Ruml plan. The provision to forgive a whole year's tax was "particularly objectionable," since the taxpayer received two years of income and paid taxes only on one year's income. Cancellation of taxes on 1942 incomes would constitute "gross violation of ability to pay." The

benefit would be distributed in inverse ratio to need. Cancellation would "bestow the greatest benefit on those best able to make economic sacrifices and the smallest benefit on those least able to make such sacrifices." About 60 taxpayers with $1,000,000 incomes would each receive a benefit of at least $854,000.

The majority report continued the argument. If taxes on 1942 incomes were canceled, the needed revenue could be obtained only by raising existing rates on the incomes of 1943 and subsequent years, which must necessarily fall on the lower or middle income groups, or by securing revenue from other sources. Since 1942 was a year of high national income and many persons, such as war contractors, realized high profits directly attributable to the war, the cancellation of 1942 taxes would have the effect of exempting war profits from their just share of taxation. In addition, forgiveness "would also impede the war effort." First, it meant gain rather than sacrifice for those on the home front; this would be detrimental to the morale of the armed forces. Second, forgiveness would stimulate the forces making for inflation by releasing funds set aside for taxes now due; this would reduce the pressure on those with 1942 tax liability to make "all possible economies."

Nine of the ten Republican members of the Ways and Means Committee joined in a minority report. It called upon Congress to substitute for what they termed "indigestible hasty pudding" the Ruml-Carlson bill. It began with tears for the poor taxpayers who would be thrown by the committee bill into "confusion and uncertainty" as to "just what they owe the government, and for what year," and for the Bureau of Internal Revenue which "would have an impossible task in trying to rescue the income tax system from the hopeless morass into which the Committee bill would plunge it."

Next came a neat disposition of the question of who would have to bear the burden of any additional taxation. The report claimed that the answer was the same under the Ruml plan, the present system or the committee bill. In any case the taxpayers in the lower and middle brackets would bear the brunt of any increased taxes, "as in the upper income tax brackets the rates cannot be increased without actual confiscation." The majority report, the minority maintained, was in serious error. It echoed, the nine Republicans said,

> the false contention of the Treasury by asserting that the Ruml plan would not only result in a shift of the tax burden from those in the upper brackets to those in the lower brackets, but would also result in a shift of the burden from old taxpayers to new taxpayers.

Current tax payment had become a partisan issue.

In a press conference on March 18, Secretary Morgenthau stated that the administration fully supported the committee bill. However, as Mr. Doughton pointed out to the House on March 25, the bill was not the product of Treasury recommendations. He stated "in direct response to unwarranted charges that the Treasury Department has written this tax bill," that

> at no time during the consideration of this bill has the Treasury Department presented any bill or attempted to usurp the prerogatives of our committee or shown any special favoritism toward any bill.

While the committee bill was being developed, the Ruml plan had been placed before the House. On January 6 Representative Carlson had introduced a Joint House Resolution embodying the Ruml plan and on March 2 had introduced it in the form of a bill. Neither of these measures had contained withholding provisions. On March 22 Mr. Carlson introduced a bill combining the Ruml forgiveness and payment principles with the withholding provisions of the committee bill; this bill canceled one entire year's tax for every individual taxpayer, which meant a cancellation of almost $10,000,000,000 of tax liabilities.

For four days, beginning on March 25, the House acrimoniously debated the Ways and Means Committee bill. To forgive or not to forgive was the question. Or, as one wag put it, "to forgive, to forget—and thus perchance to make a wartime millionaire." Chairman Doughton's own soliloquy was: "We are dealing with the most hateful, difficult problem that ever came along in the annals of mankind." He cited the handicaps under which the committee had worked. The difficulties of the task had been prejudged and misrepresented by many, but not all, newspapers, columnists and news commentators, regardless of true facts." The effect of the Ruml plan, he explained, was

to pay one year's tax out of two years' income. The question was whether, when the country was in the most desperate need of money in its history, war profiteers should escape one year's tax. Answering his own rhetorical question, he found the proposition "absurd," "ridiculous," "preposterous" and "immoral." Half or more of our taxpayers were enjoying substantially increased incomes during the war. Their ability to pay would never be greater. Mr. Doughton was trying to drive home

> the simple fact that the Ruml-Carlson plan not only favored the wealthier taxpayers as compared with their less fortunate brethren, but that it discriminated sharply against the fixed income individual while tossing into the lap of the person enjoying a swollen wartime income a golden harvest which unjustly enriches him at the expense of his government, his fellow taxpayers or both.

The sardonic Mr. Knutson, ranking minority member of the Ways and Means Committee, led the Republican fight for the Ruml-Carlson plan. He insisted that the committee bill "has no genuine friends." It was a wondrous concoction of "guile, bile and rile." Its discount provisions offered a "life-time bonus" to well-to-do taxpayers. "In short," he contended, "the New Deal majority were giving a stone to the great masses of the people, when they asked for bread."

Mr. Reed, another Republican, became tribune of the people. He considered that the real issue was whether the "44,000,000 taxpayers . . . shall have a voice as against the bureaucrats" in the method of collecting revenue.

To the plain-spoken Mr. Dingell, a Democrat, the Ruml plan was "about as legitimate as horse stealing."

> It would make countless additional wartime millionaires . . . not as a result of war profiteering . . . but as a result of the action of Congress in remitting an amount of tax money which has been legally and properly levied for the year 1942, money that has been obligated and spent for tanks, for ships, for planes and for other war purposes.

The objectionable feature of the Ruml-Carlson plan was "like work-

ing a three-shell game on the rube, Uncle Sam; he is the loser either way because there is no pea under either the 1942 or 1943 shell."

Mr. Crawford, a Republican who was siding with the majority, asked God to "forgive my party for getting caught in such a trap." Now was the time to stop inflation. According to his figures, accumulated savings for individuals had totaled $225,000,000,000 at the end of 1942. The members of Congress should take the lead in arresting the inflationary force of the "dance of the deficit billions." In his opinion, the country's political leaders lacked "just plain guts." This Congress had a duty to perform "and that duty does not consist of canceling taxes on incomes built out of war deficits."

Mr. Gearhart, the only Republican member of the Ways and Means Committee who had deserted his party, was caustic. "The pay-as-you-go, skip-a-year, turn-the-tax-clock-forward, wipe-the-slate-clean scheme" proposed by Mr. Ruml was "the plan that slogans built." To cut ourselves "a tax cake" on the home front "when our fighting men are eating cold rations in the fox holes . . . would be the last straw."

With biting sarcasm Mr. Abernethy was pleased to learn that "after 2,000 years we had discovered in our midst a real tax genius. Two thousand years of painful taxation had, at last, brought forth a painless panacea."

In his testimony before the Ways and Means Committee Mr. Ruml had stated that there was only one way to achieve absolutely current income tax payment, admittedly "impractical," and that was "to collect every night." Upon being pushed further by Mr. Cooper, his interrogator, Mr. Ruml said that an absolutely current income tax return was "something like a fresh egg; there is no such thing as an absolutely fresh egg on the market, but there are all sorts of degrees of it." In the House debate this question of degree rose to plague Mr. Doughton. Here it was a question of the degree of sin involved in different amounts of forgiveness. As dissected by Mr. Reed, it was the position of the proponents of the various bills that

> the abatement of the Carlson bill was sin; but that it was all right to sin 50 percent, or to sin the difference between 1941 and 1942, or to sin as to one class but not as to another which is the Robertson plan of sinning, or finally, as under the Doughton bill, to sin at the rate of 6, 4, 2 and 4, 3, 1, which are the rates of discount which the Doughton bill provides.

By the end of the fourth day of debate nerves were frayed and blood pressure was running dangerously high. On March 30, resolving itself into the Committee of the Whole House on the State of the Union, the House adopted an amendment embodying the provisions of the Ruml-Carlson bill by a vote of 199 to 188. Then the committee rose and the amendment was rejected in a vote by the House, 215 to 198. Immediately the House sent the committee bill back to the committee by a vote of 248 to 168.

Several bills were now introduced. They were similar in providing for collection-at-the-source, but differed in the methods prescribed for payment of liabilities not collected at the source and for making the shift to a current payment basis. Earlier, on March 23, Mr. Forand had introduced H. R. 2277, known as the Robertson-Forand bill. This bill embodied the withholding provisions and other current payment provisions which had been developed by a subcommittee of the Ways and Means Committee and submitted to the full committee on March 8. The committee rejected this bill, and after extensive consideration of alternative plans adopted a new plan embodied in H. R. 2570, introduced April 22 and reported to the House April 30.

The committee report accompanying this bill, known as the second committee bill, explained that it was providing for a cancellation of approximately one-half of the total individual liability for 1942, since the House had apparently considered that the first committee bill did not go far enough either in the direction of current payment or forgiveness. In order to facilitate a shift from the old to the new system of payment, the bill provided for the reduction of the 1942 tax to 1941 levels by applying 1941 rates and exemptions to 1942 income, and cancellation of the difference, and the payment of the reduced tax over a three-year period. A discount of 6 percent was to be allowed if the entire amount of the reduced 1942 tax was paid by March 15, 1944, and a 2-percent discount was to be allowed if one-third was paid by March 15, 1944, and the remainder by March 15, 1945. The current payment provisions covered withholding of income tax from wages and salaries at a 20-percent rate beginning July 1, 1943, and set up a system of current payment for liabilities not collected at the source. This system called for declarations of estimated tax on March 15 of each year. Revisions were permitted each quarter and quarterly payments of the tax were provided during the year when income was received, with final

adjustments to be made in March of the following year. A special rule took care of farmers; they were permitted to delay their declarations and payments until December 15. The Secretary of the Treasury gave his support in a press release to this second Ways and Means Committee bill.

The Republican minority of the committee was not in a mood to be easily satisfied. It filed another minority report, again endorsing the Ruml-Carlson plan. The revised Ruml-Carlson bill (H.R. 2245) embodied the same current payment provisions as the second committee bill, but it differed in providing full cancellation of 1942 taxes, subject to some new and complicated antiwindfall provisions, extolled by the minority as "tighter safeguards."

The first of these provisions was designed to prevent the abatement of the 1942 tax from resulting in a windfall to well-to-do taxpayers whose 1942 tax was greater than their 1943 tax. It provided that if the 1942 tax were $1,050 or more, and also more than the 1943 tax, the 1942 tax was forgiven, but the 1943 tax was increased by the amount by which the 1942 tax exceeded the 1943 tax, or by the amount which the 1942 tax exceeded $1,050 in cases where the 1943 tax was less than that amount. The second antiwindfall provision contained a special rule for cases in which both the 1942 and 1943 incomes were more than $5,000 in excess of 1941 income. In these cases, in addition to the increased tax for 1943 which the taxpayer might have under the first antiwindfall provision, the excessive portion—that is, the amount by which the 1942 or 1943 surtax net income, whichever was the lesser, exceeded $5,000 plus the 1941 surtax net income—was taxed at the regular normal tax and surtax rates for 1942, as if that portion itself constituted all of the surtax net income, and also all of the net income after exemptions and credits.

The fact that something new had been added in the way of complexity did not deter the minority pot from calling the majority kettle black. "The committee bill," stated the minority, was "a tax lawyer's dream." Three days later Mr. Doughton yielded himself an additional five minutes on the House floor to have the clerk read the complete text of the second antiwindfall provision of the Ruml-Carlson plan. The Chairman punctuated this recital with the wry comment: "You cannot explain it in three years so the average man can understand it."

On May 3 Mr. Forand introduced another version of his plan in

H.R. 2577. There was no difference between his plan and the current payment provisions of the second committee bill and the Ruml-Carlson bill except that taxpayers were made current only with respect to the 6-percent normal tax plus the first bracket 13-percent surtax. These brackets of 1942 liability were canceled for the year 1942. Only the basic liability for any year was payable currently, and there was no doubling-up of payment, since this liability corresponded to the amount of 1942 tax forgiven.

The House had three major current payment bills before it when it resumed consideration of the question—the second committee bill, the revised Ruml-Carlson bill and the revised Robertson-Forand bill. The three bills had virtually identical current payment provisions, but differed sharply in their provisions for transition to current payment and the relative distribution of forgiveness.

For two days the fires of vocal violence flared and flamed. Mr. Cooper pointed out that the Treasury would lose more than $3,500,000,000 under the Ruml-Carlson bill as compared with the committee bill. Mr. Knutson argued that the second committee bill was "not the product of reason" but a "hybrid measure representing a compromise between stubborn adherence to an unsound position on the one hand and political expediency on the other." Mr. Jennings, a Rumlite, was "for the preservation of the American taxpayer," a species which he considered so nearly threatened with extinction that "the time will come when we can put (him) on exhibition and make money charging admission for people to see him." Mr. Patman listed thirteen reasons why he opposed the Ruml plan, winding up with:

> A vote for the Ruml plan is a vote for the sales tax; a vote for runaway inflation; a vote for printing-press money; and a vote to favor the rich at the expense of the poor.

Mr. Knutson thought this was demagoguery and said so. A situation thus arose which required the Committee of the Whole House to rise so that "certain words used in the debate which were objected to" could be reported to the House.

Mr. Disney lifted the discussion from what promised to be an all-time low with a final speech against the Ruml plan. Inherent in the plan was a "redistribution of the tax burden from the few to the many,

in direct violation of the just and fundamental principle of ability to pay." The plan was "full of mistakes," and, in his opinion, it was "fundamentally unfair" to come to the House and make the claim that the antiwindfall provisions would "cure" its defects. He cited the undisputed figures in the *Record* that Charles Marcus of the Bendix Company would pay only $177 in taxes on his 1942 income of $77,000 under the Ruml-Carlson bill. Under these same antiwindfall provisions, J. D. Morrow of the Joy Manufacturing Company would pay only $282 on an income of $55,000. J. W. Frazier of the Willys-Overland would pay $477.22 on a $123,000 income. To curb inflation, Mr. Disney declared that "we should be taxing more instead of less." He underscored his point by quoting Peter Edson, the Washington columnist:

> The thunderheads of inflation now forming on the economic horizon get bigger and blacker every hour. Prices are rising, wages are rising, national income is spiraling up in a whirlwind that carries with it increased purchasing power and in whose vortex is a $40,000,000,000 inflationary gap.
>
> Despite this storm warning, there is every indication that when the House again takes up tax legislation next week, it will put through some form of tax forgiveness. It may not be the pure Ruml plan. . . . It will probably be a compromise with that idea, tailored to fit the whims of Congress and the popular notion that forgiveness of taxes is nice.
>
> . . . But what has been entirely overlooked is that for every tax dollar whose collection is canceled, the threat of inflation is just that much more real, comes just that much closer. . . . If the menaces of inflation are to be kept under any kind of control at all, now is the time not to talk of forgiving taxes, but, if anything, of increasing them. . . .
>
> "The Ruml Plan" is a good trade name that catches the eye and the ear. It is a bottle of medicine that has been smartly merchandised, but oversold as something that would put tax collections on a current basis. That it would do, but the hidden ingredient in the bottle and the potential poison is its power to induce inflation by forgiving taxes.

Once again the Ruml-Carlson bill was agreed to in the Committee of the Whole House on the State of the Union by a vote of 197 to 166, but was again rejected by the House itself, 206 to 202. The second

committee bill was recommitted by a vote of 230 to 180, with instructions to the Ways and Means Committee to report back forthwith the revised Robertson-Forand bill. This bill was then adopted by a vote of 313 to 95.

The Senate Finance Committee limited its hearings on May 6 and 7 to only two witnesses, a representative of the Treasury and a representative of the staff of the Joint Committee on Internal Revenue Taxation. For the Treasury, I presented an extensive statement describing the three bills which had been under consideration in the House, stating a preference for the second committee bill, but also opposing the Ruml-Carlson bill as compared with the Robertson-Forand bill. I contended that forgiveness added wealth to the taxpayer, or reduced his liabilities, which in effect was the same thing. I presented tables showing that a person with a $2,000 income received forgiveness of only $140, or 7½ percent, under the Ruml-Carlson bill, whereas a person with a $100,000 income received forgiveness of $64,000, or 178 percent. The tables showed also that the Ruml-Carlson bill would wipe out all increases of taxes imposed for the war effort up to January 1, 1943, for taxpayers with incomes of over $100,000, and at the $1,000,000 level would confer additional benefits of nearly $600,000. I pointed out that increases of taxes requested by the President would fall most heavily proportionately on the middle and lower incomes, since it was not feasible to raise the rates on the higher incomes proportionally. It was, therefore, impossible to impose additional taxes across the board on all the same persons who had been forgiven 1942 taxes. This meant that the tax burden would be shifted from the high to the low incomes and from the low to new taxpayers. I also pointed out that the President's request for $16,000,000,000 of additional collections meant more than the doubling of individual taxes.

The majority of the Senate Committee was receptive to Mr. Ruml's plan. Senator Taft suggested that the additional revenue secured by the Ways and Means Committee bill might be a "capital levy"; but he was satisfied with a description of the tax as possibly "payable out of capital funds." Senator Lodge did not like the word "forgive." Senator Vandenberg did not see how remission of taxes added to "real expendable wealth," as distinguished from what he called "bookkeeping wealth." Senator Connally was better able to understand that the forgiveness of a tax which had already accrued transferred the asset over to the

taxpayer. On May 7 the committee rejected the House bill *in toto* and adopted the Ruml plan by a vote of 13 to 7. Senator LaFollette alone protested, saying that the middle and lower income groups would have to pay later in one form or another not only the full amount being forgiven but also a substantial part of the 1942 taxes of taxpayers in the upper brackets.

The pay-as-you-go issue was debated in the Senate for three days. The wrangling over the formula and the degree of forgiveness faithfully followed the pattern set by the House. Senator Connally lashed out against the "dividend" on dodging a year's taxes in the Finance Committee bill. Santa Claus was here and, according to this bill, he would come every day in 1942. He was going to give $854,000 to the man with a $1,000,000 income. The doughty Texan drove home his point: The millionaire's chauffeur "is dodging taxes, and we have to place him on a current basis, so we will give the old man $854,000 back, and get $1.87 out of the chauffeur, through deductions." In contrast, Senator Clark, in favor of making taxpayers current by the 100-percent forgiveness of the Ruml plan, recalled that "Mr. Alfred I. duPont, had had an income of $4,000,000 in one year during the last war. He did not have to pay his income tax for that year until the year following. In the meantime he had lost enough in stock transactions so that he did not have to pay any tax at all. He died about that time and his estate did not have to pay anything."

In the judgment of the economy-minded Senator Byrd, it was "absurd" to believe "that this cancellation of taxes will not ultimately result in a loss of revenue to the Federal Treasury." It was "inconceivable" that if the American people knew all the facts they would be willing to adopt legislation providing for 100-percent cancellation of tax liability." To do so would mean that

> immediately a demand would be made by the President and the Treasury Department to raise additional revenue by increasing the present tax rates so as to compensate for the loss to the Treasury as a result of cancellation of the taxes of those able to pay.

Senator Davis, on the Ruml side, took the position that "to call for full taxation" was "to insist upon our pound of flesh." Senator LaFollette thought "temporary insanity" had "seized the Congress and the

country." In all the years he had been in Congress he had not known such a "sharp division of opinion among honest men."

In the most stirring speech of the entire debate Senator Bone propounded "the ethical and emotional side of the picture":

> If I could abate any of the blood and tears and agony of the boys dying on the battlefields, if I could abate one little bit of the horror facing young men marching under the American flag into this world conflict, I would abate that horror coming to them, rather than abate a year's taxes for us who stay at home. I wish I could vote to abate blindness and insanity and vote away the blasting of boys' lives by shells on the battle fronts. But we cannot do that. All we can do is to abate the tax on some fellow's income. The whole thing presents a grotesque twist of logic. It is a sort of madness.

The Senate was moved but not swayed.

The debate produced five alternatives to the Ruml plan, all of which, including a 75-percent forgiveness plan of Chairman George, were rejected. The Robertson-Forand bill was defeated by a vote of 52 to 27, and the Finance Committee bill, with complete forgiveness of 1942 taxes, was finally adopted on May 14, 1943, by a vote of 49 to 30.

President Roosevelt was concerned. On May 17 he addressed identical letters to Senator George and Chairman Doughton:

> I am eager, as I am sure the whole country is eager, to see our taxes put on a pay-as-you-go basis at the earliest possible moment. Ever since 1941 the Treasury has consistently recommended provisions designed to this end. Such provisions would help hold the line against inflation.
>
> The Senate bill, however, . . . would result in a highly inequitable distribution of the cost of the war and in an unjust and discriminatory enrichment of thousands of taxpayers in the upper income groups. . . .

He concluded:

> I am writing you now so that you may know my views and in the hope that a bill may be worked out in conference that I can sign. I have recommended pay-as-you-go taxation. I have not insisted upon any particular formula for transition to a pay-as-you-go basis. I believe that there should be substantial adjustments to ease this transition. But there are limits beyond which I cannot go. I cannot acquiesce in the elimination of a whole year's tax burden on the upper income groups during a war period when

I must call for an increase in taxes and savings from the mass of our people.

The following day Mr. Knutson asked the House to instruct its conferees to accept the Senate bill. He warned his colleagues not to be "stampeded" by the President's letter. He found "not a word in it" to indicate that the President would veto the Ruml-Carlson bill. If Mr. Knutson "understood the meaning of the English language," the President would allow the bill to become law without his approval. Mr. Doughton interpreted the President's letter differently. He was "just as certain as the sun shines and time rolls on, if this bill is sent to the President as passed by the Senate it will be vetoed." Furthermore, the House was presented with the "humiliating spectacle" of being asked to be "rubber stamps for the Senate." The Senate had not tied or bound its conferees.

The House stiffened and rejected the Senate bill by a vote of 202 to 194. The bill was then sent to conference where it remained in deadlock for several days. A compromise in favor of Senator George's 75-percent cancellation plan could not secure the four necessary votes of the House conferees until May 26 when Chairman Doughton switched his vote and broke the deadlock. The other three Democratic conferees neither changed their votes nor signed the conference report. The House and Senate agreed to the conference report by a large vote and at long last the noisy battle that had raged for many irritating weeks was done. The bill was signed by President Roosevelt at 7:00 P.M. June 9.

The Current Tax Payment Act of 1943 put wage and salary earners on a withholding basis of tax collection beginning July 1, 1943. Wage payments in certain types of occupations were excepted from the withholding requirement. The three main peacetime groups to which this exception applied were agricultural laborers, domestic servants and casual laborers. In addition, the service pay of members of the armed forces was excluded from the withholding provisions.

From the letters that came to the Treasury while this act was under consideration, it was apparent that many people, particularly in the lower wage levels, were greatly alarmed at the prospect of having 20 percent of their salaries withheld from them. Much of this alarm arose from an inaccurate conception of the withholding provisions. For the most part, these people failed to realize that withholding was not a new

tax and not an extra tax, but merely a convenient method of collecting the Federal individual income and Victory taxes. These same people also failed to realize that withholding at the rate of 20 percent was applied only to income over and above the family status withholding exemption. For a single person with no dependents, the annual family status withholding exemption was $624. For a married person or head of a family, the exemption was $1,248, with an additional $312 for each dependent.

Collection of income taxes at the source through withholding only approximated the actual income tax liability of a particular taxpayer. Every taxpayer liable for income tax was subject to a 6-percent normal tax, a 13-percent surtax and a net 3-percent Victory tax over the Victory tax exemption. These percentages totaled 22 percent on income above the family status exemption. Withholding, however, was required only at the rate of 20 percent, thus leaving a 2-percent leeway for average deductions.

Through withholding some 70 percent of the taxpayers were made substantially current in their income tax liabilities. They would have only minor year-end adjustments by way of tax payment or refund to be made at the time of filing their annual returns.

The new act required the payment of estimated tax currently by those individual income taxpayers not made current in their tax payments through withholding. In this group were persons whose wages exceeded the first surtax bracket or who received more than $100 of income from sources other than wages. Declarations of estimated tax were to be filed by March 15 of each year; payments were to be made quarterly and estimates could be revised each quarter. A special rule permitted farmers to file their declarations of estimated tax at any time up to December 15. This date was later moved forward to the following January 15.

As a means of transition to a current payment system the act provided for the cancellation of 75 percent of one year's taxes (the lower of the 1942 or 1943 tax liabilities) or $50, whichever was lower. For tax liabilities under $50 the entire amount was canceled. The unforgiven tax was payable in two installments—one on March 15, 1944, and the other on March 15, 1945. The act also contained special relief provisions for members of the armed forces, including an exclusion of $1,500 of service pay for each member on active duty.

Chapter 14

PRESIDENTIAL VETO: REVENUE ACT OF 1943

BY THE autumn of 1943 we had been through nearly two years of war. The military tide had surely turned—our way. The record of uninterrupted victories for the armies of the United States, Great Britain and Russia had been sustained since November 1942. During the year President Roosevelt and Prime Minister Churchill twice wrote history in the African sands. In January they met at Casablanca to review the scenes of recent fighting and to discuss the next phases of the struggle against Germany and Japan. In November with Generalissimo Chiang Kai-shek they drafted a charter for the Pacific beneath the tropical palms of the Egyptian desert. In December at Teheran the long-awaited meeting with Marshal Stalin put the finishing touches on plans for defeat of the Axis.

The American production front was booming. Our success was recorded in a sensational rise in expenditures, which was reflected in turn in a corresponding rise in the public debt. On June 30, 1943, the debt stood at $136,700,000,000. It was estimated that it would be about $206,000,000,000 at the end of the fiscal year 1944. War expenditures, estimated at $100,000,000,000 for the fiscal year 1944, had reached the monthly level of more than $7,000,000,000 in August 1943, the second month of the fiscal year.

Prices had also risen. The amount of inflation registered by the cost of living index since it started its upward curve early in 1941 was now well toward 25 percent. Price increases had been heaviest for food and some of the basic necessities of life. A sampling of prices by the Office of Price Administration indicated that in many instances actual retail food prices were above legal ceilings. Illicit trafficking in ration coupons, and the tendency of meat, poultry and gasoline to leak out

of regular channels and into black markets threatened price stability. Inflationary money was not easily discouraged.

Another kind of inflation was not so easily measured. This was quality inflation. It manifested itself in a deterioration of textiles which went into clothing and household supplies. It was also evident in the disappearance of "low-end" clothing from the market. Inexpensive women's house dresses, slips, aprons, men's shirts and shorts, and children's play suits vanished from store shelves. Old lines of goods were no longer produced, but apparently similar new lines were brought out at much higher prices. Typical of this kind of inflation was "overfinishing" whereby a bit of extra trimming, such as an added pocket or buttonhole, was charged for disproportionately. As shortages of material and man power developed, producers concentrated on those higher-priced items which yielded the greatest profits. The manufacturer of women's blue jeans for sportswear which sold for $2 worked his denim into highly styled dresses which sold for $59.50. The price of men's overalls remained unchanged, but workmen could find none for sale. Price control for nonexistent items could not hold the line against this kind of inflation.

In 1943 some people argued, and many others felt, that a "little inflation" was a good thing. On this subject President Roosevelt said: A "little inflation" is like opium; soon you want more, and then you have the habit.

A heavy strain on prices was inevitable. With taxes at a level of nearly $40,000,000,000 for the fiscal year 1944, the nation was faced in August with a deficit of $66,000,000,000 for the fiscal year and an almost certain heavy borrowing from the commercial banks. Huge war expenditures were reflected in the increased national income. The latest estimates put income payments to individuals at $152,000,000,000 for the fiscal year 1944—even more than that for the calendar year 1944. Direct personal taxes would skim off only $21,000,000,000, leaving $131,000,000,000 of disposable income—a figure about $50,000,000,000 higher than national income before taxes in the halcyon year 1929. The war had proved a bonanza.

Even these staggering figures did not give the whole picture. From the beginning of 1940 to June 30, 1943, the American people had saved $67,000,000,000. Of this total, $24,000,000,000 was in the form of currency and checking accounts; $23,000,000,000 was in the form of

redeemable or marketable bonds. From the standpoint of postwar inflation these savings were liquid dynamite.

Cold figures made it clear that hot dollars were also being created by commercial bank borrowing. War financing through banks is generally conceded to be dangerous. Bank purchases of government securities lead directly to an increase in cash assets held by the public. To the extent that bank depositors lend their deposits to the government by buying bonds, no new funds are created; funds are merely transferred from private to Treasury accounts. But when banks buy government securities for themselves, they have no right to make charges against their depositors' accounts; the result is that new funds are created. In payment for government bonds the banks customarily set up "War Loan Accounts" payable to the United States Treasury. As the Treasury draws on these accounts to finance war expenditures, the new funds flow into the pocketbooks and bank accounts of individual citizens and business firms.

During the fiscal year 1943 banks thus increased their holdings of Federal securities by about $30,000,000,000. This was the main factor in expanding by about 36 percent the total of coin, paper money and checking deposits held by the public. These holdings were tinder which was ready and waiting to kindle the fires of inflation.

The keynote of the administration's 1943 revenue program had been sounded in President Roosevelt's January Budget Message when he called for $16,000,000,000 of additional funds by taxation, savings or both. The Current Tax Payment Act was only a prologue to an attack on the real tax problem of 1943. The pay-as-you-go fight had been a national nuisance in that it took the eyes of the people off the main objective. No pat formula could provide an easy panacea for financing the war or holding back the floodwaters of inflation; the hard truth was that heavier taxes were needed in 1943. But consideration of the President's ambiguous request was delayed by the acrimonious pay-as-you-go controversy.

After the establishment of the Office of War Mobilization on May 28, with Mr. Justice Byrnes as Director, and the appointment of Judge Vinson as Director of Economic Stabilization, rumors filled the summer air that tax jurisdiction would be taken from the Treasury and turned over to these gentlemen. It was said that they had fewer vested irritations in Congress than did Mr. Morgenthau. The Treasury, in the

meantime, had developed five alternative plans for raising $16,000,000,000 in new revenue, and in June Secretary Morgenthau and I discussed these plans with the President as well as with Mr. Byrnes, Judge Vinson, Chairman George, Chairman Doughton and other members of the Congressional tax committees. In order to give wounds a chance to heal and members of Congress an opportunity to sound out sentiment at home, a decision was reached to postpone hearings on general revenue legislation until August or September.

Because of revised budget estimates which took into account the Current Tax Payment Act, discussions throughout the summer centered around a revenue goal of $12,000,000,000. The estimate of net receipts had been revised upward $5,000,000,000, inasmuch as withholding was being applied to a higher level of income than would have been taxed if collections had not been advanced a year. But the fact that this brought net receipts up from 32 percent to 37 percent of expected expenditures did not appreciably change the picture. In his Statement on the Summation of the 1944 Budget, August 1, the President had said:

> I recommended in my Budget Message last January a truly stiff program of additional taxes, savings, or both. I continue to support that program. The cost of living cannot be stabilized unless price and wage controls are supported by a further substantial absorption of purchasing power as a deterrent to building up prices and resorting to the black market.

In August and early September Secretary Morgenthau called three major conferences to obtain the views of other executive departments in developing an administration tax program. Among those who attended these conferences were Judge Vinson; Jesse Jones, Secretary of Commerce; Marriner Eccles, Governor of the Federal Reserve Board; Harold D. Smith, Director of the Budget; Donald Nelson, Chairman of the War Production Board; Ben Cohen of the Office of War Mobilization; Ralph Bard, Assistant Secretary of the Navy; Gerhard Colm of the Bureau of the Budget; Stacy May and C. S. Williams of the War Production Board; General Edward S. Greenbaum of the War Department; O. B. Wells of the Department of Agriculture; Samuel O. Clark, Assistant Attorney General; James V. Forrestal, Under Secretary of the Navy; Arthur J. Altmeyer, Chairman of the Social Security

Board; Ganson Purcell, Chairman of the Securities and Exchange Commission; Robert P. Patterson, Under Secretary of War; Richard V. Gilbert of the Office of Price Administration; and I. At these meetings and in further conferences at the White House, an administration program was formulated which had President Roosevelt's unqualified approval.

Early in August Chairman Doughton again met with Secretary Morgenthau. Following this conference he announced that he and the Secretary appeared to be "in agreement on most of the fundamental issues concerning the need for increased government revenue," adding, however, "I do not mean by this that we are at this time in complete agreement as to the amount of revenue to be sought." He further noted that the purpose of the new revenue bill should be "to raise revenue and to combat inflation."

To give Secretary Morgenthau an opportunity to concentrate on the Third War Loan drive, the Ways and Means Committee held up revenue hearings until early October. In the meantime, in September the committee held hearings on the renegotiation statute. In executive session the committee took up simplification of the Victory tax and slightly reduced its complexity by making the postwar credit automatic for 1943.

On October 3 a final conference was held in Secretary Morgenthau's office from 6:00 P. M. until midnight, and the lights in the Treasury Building at Fifteenth Street and Pennsylvania Avenue burned until dawn. The following morning the Secretary went to the Hill with a tough tax program, as was demanded if we were to meet war costs one-half instead of one-third by taxation and trim purchasing power into line with the shortage of consumer goods.

The Treasury program called for $10,500,000,000 of additional taxes—$6,500,000,000 of personal income taxes, including two alternative postwar credit "suggestions" of $2,300,000,000 and $3,500,000,000 which might be anticipated by those whose incomes had not increased; $400,000,000 of estate and gift taxes; over $1,000,000,000 of corporate taxes; and $2,500,000,000 of excises. In his statement before the Ways and Means Committee the Secretary also recommended in the interest of simplification repeal of the Victory tax, repeal of the earned income credit and graduated withholding to apply all the way up the surtax scale. He closed with an earnest plea for extension of the social security

system. The recommendation for a $25,000 income ceiling was not renewed, although Mr. Robertson was correct when he later commented that the increased surtaxes on personal income proposed by the Treasury would achieve substantially the same effect.

In July the Ways and Means Committee had directed the Treasury and the staff of the Joint Committee on Internal Revenue Taxation to study the question of taxing increases of individual income. Although discussions were held during the summer, no satisfactory method of accomplishing this objective was reached. The Treasury inserted in the printed record of the Ways and Means Committee Hearings a memorandum showing the impracticability of such a tax along with memoranda on *The Need for More Taxes, Postwar Expenses Related to Wartime Income,* and a comprehensive study on a Federal retail sales tax. This last study became a classic; in the words of Professor Haig it rendered "obsolete practically everything that has been previously published on the sales tax in this country."

The Treasury recommended that postwar reserves as such should not be allowed. As an alternative, I proposed to the committee, first, that corporations which incurred certain postwar expenses attributable to wartime income be allowed to carry back those expenses into the war years and reduce their war income by that amount, and second, that corporations which benefited by a carry-back of losses under the 1942 law, or of postwar expenses under this suggested provision, be allowed to take a certain proportion of their anticipated refunds currently against their postwar tax. This proposal, which was later repeated to the Senate Finance Committee, received scant attention and was not incorporated in the 1943 revenue bill. The suggestion was not forgotten, however, and in 1945 was revived and partially carried out in the Tax Adjustment Act.

The Ways and Means Committee received the Treasury's recommendations coolly. The reaction of the members took several lines, practically all of them adverse. Opposition centered on the increases in income taxes, which some members declared would constitute an "intolerable burden" for the American people. Others objected to repeal of the Victory tax, which would take 9,000,000 low income taxpayers off the tax rolls. Chairman Doughton, oblivious of his August "agreement" with Secretary Morgenthau, did not wait overnight to attack the proposals as "utterly indefensible." They brought to a

total of more than $30,000,000,000 the Secretary's requests for additional taxes in four years.

The Secretary had said that "four-fifths of all the income of the nation is going to people earning less than $5,000 a year." While it was obvious, he continued, that the economic condition of the country indicated "a great deal of room" for additional taxation, income was not distributed in such a way that it could be "equitably drawn off in huge quantities straight across any given income level." Additional income taxes of $6,500,000,000 would "impose a heavy burden on some taxpayers." The Secretary suggested that the committee might wish to consider some device for lessening the ultimate impact of the increased tax on the lower income groups such as a postwar refund of part of the tax. Gossip had it that this compulsory savings gesture was the price Mr. Morgenthau had paid to keep tax jurisdiction in the Treasury. But this was at least an exaggeration. The invasion of the Secretary's jurisdiction was more in talk than in fact. Neither Mr. Byrnes nor Judge Vinson had the organization necessary to take over tax work, and while certain of the Secretary's bond salesmen deplored this venture into compulsory savings territory, others on the Treasury staff urged the step as a method of immobilizing additional spending power in the lower income groups. Mr. Morgenthau was reluctant, but it was part of the program the President had approved and, where the President was concerned, the Secretary was a good soldier.

Mr. Knutson, to whom inflation was something of a "bogeyman," was the first to ask the oft-repeated question: "How can you control inflation through taxation unless you reach those who possess the so-called excess purchasing power?" The gentleman from Minnesota suspected the Treasury of loading the tax bill for a fourth term. He wondered "how much politics and how much revenue there were wrapped up in this bill." He went on to point out that individual taxes had increased nearly 2,500 percent in the past four years, and he was concerned about the "take-home" wages of stenographers making $35 a week. A tax of 12½ cents on a drink of liquor, he thought, might put a "premium on moonshine," and a higher tax on cigarettes might encourage people to "roll their own." Moreover, there was the old story of "unnecessary and wasteful" New Deal expenditures; there was no "excuse for boondoggling," whatever the national income might be.

Mr. Jenkins was sorry the Secretary had not been more explicit about economy, but he "sort of liked" his "discourse" on social security. The recommendation for a postwar refund seemed to him "just an easy and sly way" of commencing an enforced savings program. Mr. Dewey could not see why we must "squeeze" another $10,500,000,000 out of the people if we could save an equal amount in expenditures. At the end of the hearings Mr. Taber argued strenuously and inaccurately that Congress must "stop, look and listen" if the country were to avoid "national bankruptcy." Chairman Doughton believed that as little debt as possible should be passed on to "the boys now risking their lives by fighting on the battlefields"; on the other hand, he expected "backs to be bent" by a $10,500,000,000 increase in the tax load. He wondered how much less the Secretary would have recommended to be raised in taxes if inflation had not so seriously threatened. Later he remarked that Congress had decided that the 12½ percent payment of the 1942 taxes, in addition to current taxes, was "all the taxing that 1944 and 1945 could endure." Mr. Forand, along with the chairman, was concerned about persons who had had no increases in income.

On October 6 and 7 Judge Vinson appeared before the committee in "wholehearted" support of the "modest" Treasury proposals. The Director of Economic Stabilization did not believe we could prevent inflation in this country without a "stronger" fiscal policy. Increased taxation was "essential" to maintain stability in the wartime economy. The people were "sitting under the sword of Damocles"; they ought to be concerned with the size of the cord that held its weight, and $10,500,000,000 taken off existing purchasing power "makes the cord just a little stronger." Furthermore, the judge had heard "less complaint" in his office about the tax burden than almost anything else.

On October 21 the committee went into bitter executive session from which the Treasury representatives were frequently excluded. It had decided to substitute almost an entire new program for the Treasury's recommendations. About a month later the committee produced a bill which the House passed on November 24 by a vote of 200 to 27.

The committee report stated that changes from the present level of expenditures necessary to bring the year's final result into agreement with the August budget summation were of such great magnitudes that the deficit for the year might be reduced from $66,000,000,000 to $57,000,000,000. From the revenue standpoint the committee was con-

vinced that the need for more taxes had "apparently been exaggerated"; and lower governmental expenditures "would reduce income payments, the net inflationary gap, and pressure on prices." The committee had given "serious consideration" to the question of reducing government spending and had called the Budget Director before it to explain "the present need for such large expenditures." It believed that a "considerable reduction" could be accomplished through joint action of the legislative and executive departments and "this would lessen the tax burden which our citizens are called upon to meet."

"The maintenance by the government of the proper psychology, and freedom from fear of inflation," the committee concluded, was considerably more important than "the absorption of current excess buying power through additional taxes." It was firmly convinced that the proper psychology could be maintained only "by strict economy in governmental expenditures, through effective price control, rationing, and wage control."

Most members of the committee refused to see taxes in their role as a companion to other economic controls, and refused to recognize that the danger of inflation was so persistent and war costs so vast that a reduction in government expenditures would not reduce tax goals, but merely allow a more comfortable margin of safety in war finance. Furthermore, nonwar expenditures, exclusive of interest, were at the low level of about $4,000,000,000. Curtailments of magnitude were possible only in connection with war expenditures. Here possible reductions, that is, reductions which would not impair the war effort, did not loom very large. From the standpoint of inflation spendable income would still remain far in excess of available goods. Even a reduction in expenditures of $10,000,000,000 would do no more than give a $10,500,000,000 revenue program a better chance to hold inflationary spending power and government debt within manageable limits.

The committee also reported that the burden of direct taxes on individuals had been increasing too rapidly "and without leaving sufficient time for people to adjust their budgets." It failed to note the country's capacity to pay higher taxes and that in time of total war it was both possible and reasonable to go beyond normal levels of taxation. Comparing the fiscal year 1944 with 1940, the record showed that income payments to individuals had increased about $78,000,000,000; in the same period individual income taxes were absorbing only about one-

fourth of the increase in annual income payments being generated by defense and war activities. The question was not whether the American people could afford to pay higher taxes, but whether they could afford not to pay them.

The committee also found it vitally important that "our corporations be kept in a sound financial condition so that they may be able to convert to peacetime production and provide employment for men leaving the armed forces after the war." High corporate taxes affected the small investor and would also "seriously curtail the normal income received by charitable, religious, and educational institutions which is so necessary for them to carry on their activities."

Finally, the committee pointed out that the combined per capita burden of state and Federal taxes was $357, which was greater than in Great Britain and Canada. But the committee overlooked the fact that per capita taxes are not an indication of real burden. The proper test is the relation of taxes to the income of taxpayers. The burden of American taxes was lighter than the British and Canadian loads in terms of what counted—income remaining after taxes. Furthermore, in relation to expenditures our Federal taxes were far below the standards of Great Britain and Canada.

The Republican members of the Ways and Means Committee also held decided views against any increase in income taxes. In a minority report they stated that a further increase in personal or corporation taxes at this time would threaten "the future solvency of business" and "the liquidation of the middle class."

The bill which the committee reported on November 18 hacked the Treasury's proposals to pieces. It rejected the $6,500,000,000 increase in individual income taxes, the Treasury's main revenue reliance. By repealing the earned income credit and substituting a new "minimum" tax for the Victory tax, the bill promised an additional yield from the individual income tax of only $155,000,000. The $2,500,000,000 of additional excises, proposed by the Treasury, was slashed to $1,200,000,000; the principal excise increase brought the tax on distilled spirits from $6 to $9 per gallon. The Treasury's suggestion that the combined normal tax and surtax rates on large corporations be raised from 40 to 50 percent, and that the surtax rate for small corporations be increased 4 percentage points to yield $1,100,000,000 of additional

revenue, was ignored. Instead the committee reduced the invested capital credit of large corporations, increased the specific excess-profits tax exemption from $5,000 to $10,000, and raised the excess-profits tax rate from 90 to 95 percent to bring in $600,000,000 in revenue. The addition of $200,000,000 of miscellaneous receipts, mostly from increased postal rates, brought the total yield of the committee bill to about $2,000,000,000—less than one-fifth of the $10,500,000,000 requested by the Treasury. The bill also amended the renegotiation statute in a number of ways, some of which were objectionable to the executive departments concerned with renegotiation.

On November 29 the Secretary doggedly renewed his plea for $10,500,000,000 of additional taxes before the Senate Finance Committee. November budget figures estimating a decrease of about $8,000,000,000 in expenditures did not in his opinion warrant any lowering of goals; nor did he regard governmental economy—always a desirable objective—as "a substitute for higher taxes." Inflation still threatened, and paying any less in taxes than we could afford was unfair to those who must face the accumulated bill after the war, including 10,000,000 members of the armed forces who as "future taxpayers" would be required "to pay in taxes after the war what we could and should have paid while they were fighting." The Secretary voiced strong opposition to a retail sales tax. He answered the charge that the lower income groups would escape their fair share of the tax load under the Treasury proposals by pointing out that one-half of his suggested income tax increases would fall upon persons with incomes of less than $5,000.

I took the stand to explain the Treasury's strenuous objections to many of the "relief" provisions in the House bill and to the House "minimum" tax, which was worse than the Victory tax in that it defied the understanding of the ordinary taxpayer. The "minimum" tax—a pet brain child of the staff of the Joint Committee on Internal Revenue Taxation—was far more complicated than the Treasury proposal to simplify the individual income tax by integrating the Victory tax into the regular income tax structure. The Treasury suggested that integration should be accomplished by repealing the Victory tax, eliminating the earned income credit, reducing the personal exemption and increasing the surtax rates by 3 to 7 percentage points. This would entirely exempt about 9,000,000 Victory taxpayers, but these taxpayers would

pay only $275,000,000 under existing law, and only $161,000,000 under the House bill. At small cost much auditing and policing work for the Bureau of Internal Revenue would be eliminated.

Much more important, the Treasury was convinced that a tax law affecting over 50,000,000 people must be made understandable if it were to survive. The people had been promised relief from the complexities of the existing dual tax structure. The law must be explainable over the radio, through the press and in the mails. I could visualize mechanical guides which would help taxpayers, who stumbled in robot fashion through income tax compliance under the House bill, but I could conceive of no information campaign that would make the minimum tax understandable to taxpayers generally. The minimum tax jeopardized the whole income tax system. Merely to collect $161,000,000 from 9,000,000 taxpayers near the bottom of the income scale it endangered the collection of some $17,000,000,000 from 50,000,000 taxpayers throughout the scale. The minimum tax cure was worse than the Victory tax disease.

To the Ways and Means Committee the Treasury had suggested in the interest of simplification the consolidation of the normal tax and surtax schedules with proper protection to the government so that there would be no increase in the exemption benefit to the holders of partially tax-exempt Federal securities. It had also proposed withholding on a graduated basis so that the full tax liability of taxpayers might be collected at the source. These suggestions were renewed before the Finance Committee.

Members of the Finance Committee were impressed with the Treasury arguments against the "minimum" tax, but not its arguments for higher taxes. Chairman George was worried about rapidly increased taxes on stationary incomes and feared that an increase of the 80-percent corporate ceiling, in which Senator Vandenberg appeared interested, might "destroy" business. Others were less communicative in the opening session, and a procession of witnesses followed with "relief" suggestions.

The Forest Industries Committee on Timber Valuation and Taxation and the American Turpentine Farmers Association Co-operative sought an amendment which would permit companies which cut their own timber to pay taxes on the basis of the comparatively low capital gains rates instead of including profits in normal income. The natural gas

industry wanted to retain a House provision granting excess-profits tax relief on accelerated output. The potash industry and the coal industry asked for percentage depletion and special excess-profits tax treatment which had been allowed in the House bill.

The stepped-up excises brought forth cries of protest from every "interest" that was "hurt." The Metropolitan Opera Association came to plead for an exemption from the Federal admission tax on tickets. The Governor of Florida, the Chairman of the New York State Racing Commission, and others were vocal against a 5-percent tax on pari-mutuel wagers at race courses. The fur industry, the night-club owners, the jewelers, the pharmacists and druggists, and the luggage and pocket-book manufacturers formed a united front against increased excises. And so it went through 1,173 pages of testimony from November 29 to December 6.

The Finance Committee held executive sessions from December 7 to December 16 and one additional session on December 21. The committee endorsed the objectives of the House bill and opposed any appreciable increases in individual or corporate tax rates beyond those in the House bill. It accepted neither the minimum tax nor the Treasury integration plan, but changed the Victory tax to a flat 3-percent rate for all persons regardless of marital status. The 1-percent social security tax, which would have been doubled automatically in March, was kept at its existing level.

The committee dealt not only with taxes but also with the renegotiation statute, passed in April 1942. This had been the subject of extensive testimony before the Ways and Means Committee, and the House bill included a number of amendments to that statute, among them a provision, objected to by the Treasury, permitting aggrieved contractors to secure a redetermination of excessive profits by the Tax Court. Complaints of contractors voiced before the Finance Committee, particularly that of Colonel Willard F. Rockwell, Chairman of the Board of the Timken-Detroit Axle Company, moved Under Secretary of War Patterson to protest.

Mr. Patterson testified to eighteen months' experience with the renegotiation statute. It had saved the government a gross total of $5,300,000,000—$2,500,000,000 of recoveries and $2,800,000,000 in price reductions—or a net total which would not have been recovered by taxes of $1,500,000,000. In the opinion of the War Department and all of the

other renegotiating agencies it was necessary wartime legislation to protect the government as far as possible against profiteering. The charge that it had been administered unfairly could not be "sustained." The Under Secretary described in great detail the way in which the statute worked and he and Major General Clay answered "Brother" Rockwell's charges at length, and other secondhand complaints made through Senators. Some contractors were disturbed by the slowness and uncertainty of renegotiation. Others insisted that renegotiations were subject to renegotiation. Mr. Patterson then stated that he had no objection to a judicial review of excessive profit determination, though he went along with the Treasury's recommendation that review be placed elsewhere than in the Tax Court; he thought there was such a right under existing law.

This and additional testimony presented by other department heads failed to impress the majority of the Finance Committee. Renegotiation was "an innovation in our system of government," and it must be made clear that such a supplement to the taxing power should be "exercised in a fair, equitable, and constitutional manner."

The Finance Committee bill contained a provision, originally inserted in the House bill, permitting contractors to reopen in the courts all "closed" renegotiation cases, that is, cases which had resulted in voluntary agreement between the government and the war contractor. There could be no valid objection to a procedure which protected contractors in their right to a fair determination of the facts and to adequate judicial review of decisions of administrative agencies. However, that principle could have no application to those cases in which agreements had been reached. Attempts to make it applicable to them fell wide of the mark. The adoption of this provision would mean that over 8,000 cases, involving over $5,000,000,000 of refunds and price reductions, might be reopened and interminably litigated.

Another provision, carried over from the House bill, restricted the application of the act by making it apply only to contracts or subcontracts for "components" of articles actually delivered to the government under prime contracts. It exempted from renegotiation a large group of subcontractors who had admittedly made excessive profits. To make matters worse, it was made retroactive, requiring the government to refund millions already recovered from those companies.

A mandatory exemption for "standard commercial articles" exempted

from renegotiation the profits—however excessive they might be—from the sale of these articles. The record showed that exorbitant profits were being earned on a large scale by concerns that produced standard commercial articles. As a matter of fact, contractors who made standard commercial articles held a more advantageous position than other war contractors. Since they were making their peacetime products, they had fewer conversion problems. Apart from the merits of this exemption, there would be interminable debate as to what contracts were subject to the act.

Still another provision required the renegotiating agencies to take estimated taxes into account for the purpose of determining excessive profits. This was an anomaly in a measure that was concerned with the establishment of sound prices. It fundamentally changed the character of the renegotiation process from a repricing procedure to a super-excess-profits tax. It shifted the war contractor's war tax burdens to the government. More precisely, it transferred the war contractor's war tax load from his own shoulders to those of other taxpayers generally.

Finally, the bill contained a provision requiring the renegotiating agencies to include as a cost in the determination of excess profits carry-backs of operating losses, as well as amortization recomputations. This provision made it impossible to conclude a renegotiation agreement within any reasonable time.

These amendments emasculated the statute. Their adoption would have made it worse than nothing; it would have left a façade of war-profits control with no reality behind it. *Business Week*, in its December 18, 1943, issue, cited the Finance Committee's "very scientific demolition job" on the renegotiation law. "The Committee," it said,

> shrewdly avoided voting for outright repeal, knowing Congress would find that hard to take in an election year. Instead, it was trying to get the same result by trimming down the scope of the act and by curtailing the authority of the Price Adjustment Boards.

On January 6, Senators Walsh, LaFollette, Connally and Lucas issued a minority report protesting the revisions in the renegotiation statute proposed in the Finance Committee bill. Recognizing the statute as "strictly a war measure" which could not be defended in peacetime, the report gave the history of the statute, told of the profiteering in World

War I, discussed the difficulties of preventing war profits, summed up the development of renegotiation and listed the requisites for effective renegotiation. Following a detailed discussion of the Finance Committee bill, the minority concluded that

> to wage this war, the Nation must expend its substance and the lives of its young men on an appalling scale. Despite much talk of equalizing the sacrifices, that can never be done in sober fact. To achieve the defeat of Hitler and Japan, thousands must contribute their lives or broken bodies. Measured by their sacrifice, any lesser contribution of time, or effort, or money seems but a paltry mite. Equality of sacrifice there can never be. To those who die or are maimed we must remain eternally in debt.
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> But if we cannot match their supreme sacrifices we must do our best to spread the burdens of the war as fairly as we can. Every class and group must do its share to carry the Nation's war load. Above all else, we must make certain that no group or class shall exploit the war for its selfish benefit. That is but simple fairness to our soldiers and sailors and also to our people—who are enduring unwonted restraints and burdens for the common good.
>
> In the two decades since the last war, the people made the firm and deep resolve that in another war no one should be allowed to enrich himself by inordinate profits from the Nation's war goods. In this war, profiteering must be outlawed.

Criticizing the radical departure of the Finance Committee bill from "this national determination to prevent profiteering," the minority concluded that the bill "sowed the seeds of a new crop of war millionaires," that it would "breed bitterness and resentment among the people" and that it "would be more honest to repeal the Renegotiation Act altogether than to weaken it fatally by these amendments."

A storm of protest followed the Christmas holidays. The majority of the Finance Committee, after several conferences with the Under Secretary of War, his able assistant, James McIntosh, and several others of us, reconsidered its bill and revised the renegotiation sections before they reached the floor of the Senate. But they left the provision that renegotiation should end with the year 1944 unless the President extended the act, which he might do only until June 30, 1945, and also the provision making amortization a cost in the determination of excess profits.

Many of the tax provisions of the bill were equally indefensible,

especially in time of war. The bill endorsed a number of "special privileges" later mentioned in the President's veto message. One of them permitted corporations reorganized in bankruptcy to retain the high excess-profits credit and depreciation basis attributable to the contributions of stockholders who were usually eliminated in the reorganization. This privilege inured to the benefit of bondholders who, in many cases, had purchased their bonds in the speculative market for far less than their face value. It opened the door to further windfall profits in this market because of the undeserved benefit received by reorganized corporations.

Another special privilege was the extension of percentage depletion allowances, already one of the principal loopholes of the tax law, to such minerals as vermiculite, potash, feldspar, mica, talc, lepidolite, barite and spodumene. In the case of some of these minerals the War Production Board refused to certify that current output was inadequate for war needs. Vermiculite, a plentiful material, was added to the list of strategic minerals the income from the production of which was exempt from the excess-profits tax. The lumber industry was permitted to treat income from the cutting of timber, including selective logging, as a capital gain rather than regular income. Natural gas pipe lines were exempted from the excess-profits tax without justification and in a manner which might well lead oil companies to request similar treatment for their pipe lines. Commercial air lines were granted an unjustifiable extension of the tax subsidy on their air mail contracts.

Still another provision, lost in later conference, would have permitted railroads to deduct from wartime income the full amount of losses realized upon the sale of their stock investments in other railroads. The railroads had contended that they had been encouraged by the government to acquire these securities after the Transportation Act of 1920 in furtherance of a policy of railroad consolidation. The fact, correctly stated in a courageous letter of Joseph B. Eastman, a member of the Interstate Commerce Commission, which turned the tide against the provision, was that most of the securities had been acquired prior to 1920 and that those acquired after that date had been acquired without the approval of the Interstate Commerce Commission and for the purpose of preventing consolidation. The amendment, if passed, would have extended to railroads the privilege—not granted to other investors—of deducting old losses, mostly sustained in

the depression, against wartime income. It would have cost enough in revenue to make the yield of the revenue act negative.

The Revenue Act of 1943 did not become law until 1944. It was reported to the Senate on December 21, but debate was delayed until after a Christmas recess. Congress had gone home and decided not to come back until January 10.

On January 10 President Roosevelt sent to Congress his 1945 Budget Message calling for a "truly stiff fiscal program" as one of the "financial requirements for victory." He reiterated the need for additional wartime taxes in at least the amount requested by the administration in October. Nothing had occurred to indicate that this tax program was "more than a minimum." The necessity for additional revenue was becoming "increasingly acute" as the war continued. The failure thus far to enact an adequate fiscal program had "aggravated" the difficulties of maintaining economic stabilization. The time to impose high taxes was "now" when incomes were high and goods were scarce. Additional revenue beyond that provided in the bill pending before the Senate was urgently needed.

The following day in his State of the Union Message the President reinforced this plea. He asked Congress to adopt a five-point program to help win the war and maintain a stable economy at home. First on the list was enactment of a "realistic tax law . . . which will tax all unreasonable profits, both individual and corporate, and reduce the ultimate cost of the war to our sons and daughters." He added that "the tax bill now under consideration by the Congress does not begin to meet this test."

Unmoved by these admonitions, the Senate passed the revenue bill on January 21, and after conference it went to the President on February 10. On February 22 the President vetoed the measure in a sharp message branding it as "not a tax bill but a tax-relief bill providing relief not for the needy but for the greedy." He found it "wholly ineffective" as a revenue measure.

The President objected to the postponement of the automatic social security increases, to the termination of renegotiation authority at the end of 1944 (with a six-months' extension), to the provision permitting renegotiation appeals to the Tax Court, and to the bill's failure to simplify taxes by eliminating the Victory tax and adopting graduated withholding. It was "replete with provisions" which afforded "indefensible

privileges to special groups" and set "dangerous precedents for the future." The President said it had been suggested that he should give his approval to the bill on the ground that having asked Congress for a loaf of bread to take care of this war for the sake of this and succeeding generations, he should be content with a small piece of crust. He might have done so if he had not noted that the small piece of crust contained so many extraneous and inedible materials. Against the official advice of the Treasury, but with the concurrence of others in the administration, the President refused the "small piece of crust."

Speculation as to who wrote the veto message was rife. Authorship was variously attributed to Judge Samuel Rosenman, Judge Vinson and me. A day or so before the message was sent to the Hill, Mr. Byrnes asked me to go over the technical section relating to the special privileges which were afforded to "favored groups." I revised the section and rushed it to the White House where we discussed it briefly. Mr. Byrnes was in great haste to get it to the President and said they would take my word for the part I had revised. Judge Rosenman was accused of supplying the fighting phrases which caused such a furor, but actually he did not see the message until it was completed. My first view of the message was in my brief conference with Mr. Byrnes and, apart from some complaints with respect to the termination of renegotiation and the necessity for simplification, my contribution was on a technical level. My private views—not communicated to the President—were in favor of a veto. Various memoranda were supplied to the President; none that I saw contained the phrases which aroused the wrath of Congress.

Stung by the veto, members of Congress retorted hotly. The President was accused of waging deliberate war on the legislature. Eighty-year-old Chairman Doughton "couldn't maintain" his "self-respect" if he didn't vote to override the veto. To Mr. Knutson this was the "most crucial test between the executive and legislative branches that has ever arisen"; it "transcended" the Supreme Court fight. Senator George could not refrain from pointing out "by way of factual analysis" the "wholly unsatisfactory and inconclusive ground upon which the President has been misled into vetoing the bill." There was such a thing as "too much taxes" and he saw no reason "to cut down the tree in order to get the fruit." In the furious Congressional counterattack nineteen of the twenty-five members of the Ways and Means Committee issued

a statement declaring that the administration's $10,500,000,000 tax program would have been "oppressive to taxpayers and dangerous to the national economy," and "would threaten the solvency of all business and undermine its ability to provide jobs when the war ends."

The climax came on February 23 when Senator Barkley, who had "carried the flag of this administration for seven years over rougher territory than was ever traversed by any previous majority leader," dramatically resigned his Senate leadership to protest the veto. With the words of the message rankling in his breast, he declared in a forty-five-minute speech that the President's action was a "calculated and deliberate assault" upon the legislative integrity of every member of Congress, and added that he did not propose to take the attack lying down.

> If the Congress of the United States has any self-respect yet left, it will override the veto of the President and enact this bill into law, his objections to the contrary notwithstanding.

The Democratic conference promptly accepted his resignation and immediately re-elected him unanimously as the "new leader," a course which the President had suggested in a conciliatory note to "Dear Alben."

Senator Barkley's startling move gave rise to sundry wisecracks in Washington. One was that the President could now call the Kentucky Senator "Perfidious Alben" instead of "Dear Alben." Another was a parody on the popular song, "Mairzy Doats":

> "When Barkley bolts and Doughton bolts
> Then F. D. R. eats ivy—poison ivy, too."

Some of the Senator's constituents were reported to believe that the "Sage of Paducah" had put himself in a highly strategic position to cope with possible shifts in the political tide. Others said he had made himself a natural choice for Vice-President. What no one then realized was that he may well have talked himself out of the Presidency. Such are the folkways of politics.

On February 24 the House overrode the veto by a vote of 299 to 95. The next day the Senate followed with a smashing majority of 72 to 14, and the measure went down in history as the first revenue act to become law over a presidential veto.

Chapter 15

SIMPLIFICATION FOR THE MASSES: INDIVIDUAL INCOME TAX ACT OF 1944

IN 1944 man's inhumanity to man explored new depths. It was a bloody, violent, desperate, hopeful year. But the peace that many men in high places had said would come did not come. As the year began, a Wermacht totaling 6,000,000 men stood astride the Continent of Europe. But not for long. For this was the year in which the invasion of Western Europe would begin and the Allies would launch their grand offensive against the Nazis. On June 6 the tensely anticipated D-Day would arrive; the sky would be streaked with Allied planes; the English Channel would swarm with ships; and a quarter of a million men would blacken the beaches of Normandy in the first twenty-four hours. This was the signal for a vast Red Army offensive to sweep the Germans out of White Russia and the eastern half of Poland, knock Rumania and Bulgaria out of the war, and swing up the Danube to Budapest. In the Pacific, in 1944, after two years of slow and arduous moves, the United States Army and Navy would strike daring blows in dazzling profusion; in February would come the invasion of the Marshall Islands; in March, the invasion of Saipan; and in October General MacArthur would make good his promise to return to the Philippines.

In 1944 the United States had become more an "arsenal of democracy" than the coiner of that phrase had even dreamed. Our war costs had mounted to nearly $250,000,000 a day, or about $1,750,000,000 a week. But no one was touched by this cost as by the cost in human life. The people dreamed of peace. They complained about cigarette, gasoline and meat shortages, but most of all they complained about taxes. It was not the amount of taxes they paid that aroused their anguish; it was the suffering they endured in filling out their income

tax returns. They were tortured with complexity and they resented the callousness of a government that expected them to be bookkeepers, accountants, lawyers, tax experts and war workers, all in one.

But the people had their champion. In his Budget Message on January 10 President Roosevelt had said:

> I . . . recommend tax simplification to reduce the burdens of compliance of the many million taxpayers by elimination of returns where feasible and by other measures—provided such changes do not result in substantial impairment of receipts for the Treasury or of equity for taxpayers.

In his February message vetoing the Revenue Act of 1943 the President had been more emphatic:

> The American taxpayer has been promised of late that tax laws and returns will be drastically simplified. This bill does not make good that promise. It ignores the most obvious step toward simplifying taxes by failing to eliminate the clumsy Victory tax. . . . The suggestion of withholding at graduated rates, which would relieve millions of people of the task of filing declarations of estimated income, was not adopted. I trust . . . that the Congress, after all these delays, will act as quickly as possible for simplification of the tax laws which will make possible the simplification of the forms and computations now demanded of the individual taxpayers. These taxpayers, now engaged in an effort to win the greatest war this nation has ever faced, are not in a mood to study higher mathematics.

Following this blast Arthur Krock had taken up the cudgels for Congress, contending that the complicated tax forms were "an intergovernmental sin if ever there was one." Congressional resolve to do something about simplification was doubtless strengthened by Chairman Doughton's admission in September that he had to hire a tax expert to help him prepare his own return. The Chairman of the Ways and Means Committee had been caught, at least partially, in a web of his own weaving. Early in January Mr. Doughton feelingly announced that tax simplification was "the Number One job" for his committee.

The Treasury was gratified to note that its oft-repeated pleas for simplification were about to be translated into action. In October 1943 Secretary Morgenthau had told the Ways and Means Committee that

it was vitally important to take every possible step to reduce the complications in our tax laws which made it necessary to fill out long and difficult forms. During the summer and fall of 1943 and the winter of 1944, I made a number of speeches in the Midwest and New England, suggesting specific remedies for Joe Doakes' tax headaches.

Simplicity could not be expected to spring Minerva-like, full-born from the Ways and Means Committee. Its achievement would be a painstaking and tedious process. But simplicity was imperative if our tax system was to survive. The necessity of simplifying provisions for the benefit of a large number of taxpayers had intensified in the war years. In 1932 we had slightly less than 2,000,000 taxable returns. There were about 40,000,000 for 1943. A reasonable number of complications might be handled in 2,000,000 returns. To handle complications in more than twenty times that number was a very different matter. While our tax system might safely, though not wisely, irritate 2,000,000 citizens, it would run serious risks if it irritated 40,000,000 or 50,000,000.

In recognition of this grim fact the Treasury had made many suggestions, some at the cost of reducing the revenue. In 1941 it had recommended the short form return to Congress. In 1942 it had suggested the elimination of the earned income credit, not because it was out of sympathy with some differentiation in favor of earned income, but because the misnamed earned income credit in the law was not worth the complexity it involved. This credit was removed in the Revenue Act of 1943. In 1943 the Treasury had urged the elimination of the Victory tax, and consolidation of the normal tax and the surtax into one tax, in order to avoid the necessity of separate calculation. It had also urged that collection-at-the-source be made to apply on a graduated basis to the taxpayer's full liability rather than his partial liability under the first bracket.

Employers responded enthusiastically to this recommendation. Employer groups with whom the Treasury discussed withholding problems signified the desirability of graduated withholding from the standpoint of their relationships with employees. At the time for filing the first quarterly declarations in September 1943, several large employers reported that requests from employees for information concerning total amounts of wages and withholding over the year, as well as for assistance in the computation and preparation of tax forms, re-

sulted in significant additional burdens for their tax and accounting staffs. The question arose whether graduated withholding would unduly complicate the preparation of payrolls. Careful study, as well as discussions with employers, indicated that little or no extra burden upon employers would result.

Investigation of this proposal revealed further interesting data. In 1944 the first $2,000 bracket would cover about 34,000,000 taxpayers. The remaining twenty-three brackets would cover less than 7,000,000 taxpayers. The lesson of these figures was that our rate structure lacked refinement for the great majority of taxpayers. Thirty-four million taxpayers had the same rate of tax on their income without any nominal rate progression. The progression in our tax rates was limited to the remaining 7,000,000 taxpayers. However, the moment better progression was attempted, graduated withholding became a necessity. The by-product of graduated withholding—which would help achieve the desirable objective of refining the rate structure for the great majority of taxpayers—would be the elimination of quarterly declarations for all persons who had salaries above the first bracket of surtax and no other substantial source of income. A greater number of declarations could be eliminated if, in addition, the requirement that declarations must be filed by persons who received $100 or more of income from sources other than wages was raised to place the outside income at a somewhat higher figure.

In January of 1944 millions of taxpayers looked ahead with awful foreboding to the Ides of March. They not only must file their returns for 1943, but at least 12,000,000 also faced the necessity of declaring their 1944 incomes. In December the Bureau of Internal Revenue had released the 1944 versions of Form 1040 and the short form, 1040A. One newspaper expressed its reaction in no uncertain terms: "It must be seen to be believed. The form and its junior sister Form 1040A are so complicated as to defy description in a newspaper during a paper shortage." This statement was but a preface to a long series of bitter complaints.

The returns due in March 1944 would have a new understructure. For the first time taxpayers would have paid some or all of their tax liability in advance. Many would have made payments under four different headings:

1. March and June 1943 installments based upon their 1942 returns;
2. Victory tax withholding in the first half of 1943;
3. Income tax withholding in the second half of 1943; and
4. September and December 1943 installments based upon estimated 1943 income.

In March 1944 they would have to compute 1943 income and Victory tax and compute and pay one-half of the uncanceled fraction of the 1942 tax. Many would also have to file a declaration of estimated tax on 1944 income, and make the first quarterly tax payment for 1944. The signs pointed to a bull market in aspirin.

Many people do not realize that income tax returns are but the outward and visible sign of the legislation which makes them what they are. Return forms must be prepared by the Bureau of Internal Revenue. But the Bureau is not a free agent; it works under a statute which it does not pass. In 1944 the statute was necessarily complicated because the tax structure was being changed over to a pay-as-you-go system. No statute could entirely eliminate complexity during this shift from one payment method to another. But the transition process did not account for all complexities.

In January the Treasury and the staff of the Joint Committee on Internal Revenue Taxation began intensive work on tax simplification. In February and March a jointly developed plan was discussed in a series of meetings with the Ways and Means Committee. No public hearings were held. On March 10 Secretary Morgenthau wrote to Chairman Doughton and Senator George that the work was nearing completion and recommendations would soon be submitted to the Ways and Means Committee. "Speedy enactment of the proposed legislation," he said, "seems to me to be of the very first importance." A week later the Ways and Means Committee announced its tentative approval of a simplification plan. Senator George, the Finance Committee Chairman, wholeheartedly endorsed the plan. Secretary Morgenthau hastened to give the Ways and Means Committee credit for "a great piece of work" which had been done "with dispatch and without confusion of any sort." The result, he predicted, would prove a great boon to the country.

Agreement on the bill, modified only slightly by changes in the Ways and Means Committee and the Finance Committee, was so widespread

that no dissenting vote was recorded in either house of Congress. To the harassed taxpayers it was clear that the stormy routine of taxpaying would never be so bad again. Mr. Cooper, delighted with the progress that had been made, said there had never been "anything like" this bill in simplification. On May 29 President Roosevelt signed the measure which would relieve a considerable part of the mental, if not the financial, pain of taxpaying for about 30,000,000 people.

The Individual Income Tax Act of 1944 simplified the income tax for persons with small or moderate incomes without materially affecting its yield. The distribution of the tax burden was not affected as between high and low incomes; there was, however, some shift as between large and small families. The loss of revenue was only about $60,000,000 out of a total yield from the individual income tax of approximately $17,000,000,000, a loss which the Ways and Means Committee—and certainly the relieved taxpayers—considered justified in the interest of simplification.

The act made several important changes in existing law. The personal income tax exemption, for the surtax, was made uniform at $500 per person. The Victory tax was repealed and replaced by a new 3-percent normal tax on net income in excess of $500. The former normal tax was absorbed into a new surtax schedule with rates ranging from 20 to 91 percent.

In the group of nearly 30,000,000 taxpayers who were relieved of the headaches of tax computation were persons who received income of less than $5,000, all of which (except up to $100) consisted of wages or salaries subject to withholding. They were permitted to file their withholding receipts with their collectors of internal revenue, as optional tax returns. The collector would then determine their tax liability and mail a refund check where there had been overpayment through withholding, or send a bill for any additional amount due.

The withholding provisions of the act, effective January 1, 1945, provided for more accurate collection-at-the-source than before. Under the new withholding procedures a standard allowance of 10 percent for deductions was accorded to correspond with the 10-percent allowance in the tax table to be used by the collector in determining the liability of salary and wage earners who reported on the simpler return. Collection of approximately the full tax liability for wages and salaries up to at least $5,000 was achieved by graduated withholding through

the second surtax bracket. Accuracy was further increased by providing new withholding tables with wage brackets substantially narrower than those in the tables under prior law.

The act also simplified compliance for taxpayers who would continue to determine their own tax liability. About half of these taxpayers would be able to avoid actually computing their tax by using the expanded tax table provided in the act. The new table provided amounts of total tax for "adjusted gross income" (defined in general as gross income less business deductions) up to $5,000, and its use was not limited to any particular types of income. The tax was derived on the basis of the 10-percent standard allowance for deductions, thereby eliminating the task of itemizing personal deductions where the table was used. The act gave taxpayers with adjusted gross income of $5,000 or more—who could not use the table—the option of claiming a $500 standard allowance in place of itemizing their personal deductions. However, regardless of size or type of income, the taxpayer might elect to claim his actual deductions instead of the standard allowance.

In addition, the act simplified the definition of a dependent and the treatment of a dependent's income. A dependent was redefined as any closely related person for whom the taxpayer furnished over half of the support, provided that the person did not receive gross income of $500 or more. Mr. Robertson termed this provision "a break for large families." Lifting the requirement that a dependent must be under 18 or incapable of self-support, he said, "should help to see the kids through college." The act also provided that the earnings of a minor were to be included in his own income and excluded from the gross income of the parent.

By simplifying declaration procedure, the new law relieved about 4,000,000 people from filing declarations of estimated tax. Under prior law taxpayers—even those with less than $100 of income from sources not subject to withholding—were required to file declarations whenever their anticipated wages and salaries exceeded $2,700, if single, or $3,500 if married. The requirement was now raised to $5,000 plus an additional $500 for the taxpayer's spouse and each of his dependents.

The date for filing the final declaration and for paying the final installment of estimated tax was moved forward from December 15 to January 15 of the following year with the additional provision that,

on or before January 15, taxpayers might file their final returns instead of a declaration required on that date.

For purposes of the declaration requirements the act also altered the definition of a farmer. Under prior law a farmer was defined as a taxpayer who derived 80 percent or more of his gross income from farming. This requirement was lowered to 66⅔ percent.

Chapter 16

EASING RECONVERSION: TAX ADJUSTMENT ACT OF 1945

In his Message on the State of the Union in January 1945, President Roosevelt said:

> This new year of 1945 can be the greatest year of achievement in human history. Nineteen-forty-five can see the final ending of the Nazi-Fascist reign of terror in Europe. Nineteen-forty-five can see the closing in of the forces of retribution about the center of the malignant power of imperialistic Japan. Most important of all—1945 can and must see the substantial beginning of the organization of world peace.

All those hopes, and more, were fulfilled in 1945. Spring brought victory in Europe. The strange insane monstrosity that was Nazi Germany had finally been beaten into submission. To millions of people the unconditional surrender in the school building in the French city of Reims on the morning of May 7 meant the end of all suffering. But VE-Day came too late for the man who had shattered all precedents to become President of the United States four times. Franklin D. Roosevelt, who had led the nation through nearly three and one-half years of war, passed quietly into history on April 12 within sight of the victory he had charted and planned and the peace he had hoped to help write. On the evening of the same day Harry S. Truman became the thirty-second President of the United States.

Before it recessed in the summer of 1945 a war-weary Congress cleared the decks of all legislation to enable the United States to take a leading role in world affairs. It voted extension of the Reciprocal Trade Act, and approval of the Bretton Woods Agreements, which set up an International Monetary Fund and an International Bank for

Reconstruction and Development as a first step toward economic peace. It voted expansion of the lending powers of the Export-Import Bank to assist other nations in the restoration of their economies and directly expand the foreign trade of the United States. It voted approval of United States membership in the United Nations Food and Agriculture Organization, and extension of the Lend-Lease Act. Finally, by ratifying the United Nations charter it made the United States a member of a new world union for peace.

In July President Truman sailed for Europe to deal with the drab business of cleaning up the wreckage of a war that had been won. The Potsdam Conference held in the Cecilienhof Palace, whence Kaiser Wilhelm had launched Germany's first attempt at world domination, stirred the imagination of mankind. Its seventeen days of meetings were interrupted by news of the biggest electoral upset in British history. For the first time the Labor party had gained a majority in the House of Commons. In Britain's "revolution by consent" the invincible Churchill, champion of forlorn hopes, was replaced as Prime Minister by Clement Attlee.

In May of 1945 the biggest task confronting the nation beyond defeating the Japanese was nothing less than turning the country back from wartime production to production for peaceful pursuits. By midsummer the pressure upon the national economy was gradually easing; reconversion and demobilization had begun. With cutbacks in war production to the demands of a one-front war, the major questions confronting business and government were how rapidly new private investment and the short supply of consumption goods could be expanded and by what means reconversion could be speeded.

Insofar as tax adjustments would help to meet these problems, preliminary studies on transition and postwar tax problems had been undertaken in the winter of 1944 and 1945 by the Joint Committee on Internal Revenue Taxation for Postwar Taxation. This committee was composed of twelve members, six from the House Ways and Means Committee, and six from the Senate Finance Committee, with equal representation for both political parties. It was assisted by the tax staffs of the committee and the Treasury.

The committee's conclusions were set forth in a report made public at a press conference held by Chairman Doughton, Senator George and Secretary Morgenthau on May 10. This report recommended

changes in the operation of taxes affecting business for the interim period between the end of the European war and the end of the war with Japan. These changes did not, for the most part, involve any reduction in ultimate tax liabilities. They were designed primarily to facilitate reconversion by improving the cash position of business enterprises and by relieving small business of some or all of the burdens of the excess-profits tax.

On June 18 Chairman Doughton introduced a bill in the House incorporating the recommendations of the Joint Committee for a tax revision program designed to improve the cash position of business by advancing the time for payment of money owed by the government to taxpayers which, under existing law, might not be paid to them for several years. In addition to quicker refunds, the bill contained a provision to help small business by increasing the specific excess-profits tax exemption from $10,000 to $25,000 after December 31, 1945.

On June 20 the Ways and Means Committee decided to consider the measure without holding public hearings. An amendment by the irrepressible Mr. Robertson to apply the $25,000 excess-profits tax exemption to 1945 income was defeated in committee by a vote of 14 to 11. But in the closing hours of its session the committee adopted by a divided vote an amendment granting special relief to certain reorganized railroads which, in effect, would put these railroads on the same footing as their predecessors for the purposes of the net operating loss and unused excess-profits credit carry-overs and carry-backs. Under the amendment a reorganized railroad would be able to get refunds of excess-profits taxes paid by its predecessor company, although its ownership might be entirely different from the ownership of the original company. Likewise, it might be able to avoid current excess-profits taxes by using exemptions from the tax that its predecessor company had not been able to use.

The committee explained that the bill did not reduce existing tax rates because:

1. Federal expenditures would remain high during the war with Japan.

2. Reasonably full employment was anticipated during the period of the war with Japan, since the pent-up demand for civilian goods and services was expected to offset the cutback in war production. Such

unemployment as might exist would be largely caused by unavoidable delays in plant reconversion and was likely to be limited to a few areas which would be affected by large cutbacks in war production. General tax reductions would be of little help to these isolated areas.

3. Tax reductions at this time might be an important factor in starting a runaway inflation by increasing the demand for the short supply of civilian goods and services, and by weakening other anti-inflationary controls.

4. The armed forces were still being called upon to endure personal and economic hardships.

On July 2 the Rules Committee headed the House into a contest over whether the increase in the excess-profits tax exemption should apply to 1945 or 1946 income, as proposed in the rejected Robertson amendment. Members of the Ways and Means Committee appeared before the Rules Committee and asked for a "closed" rule, forbidding amendments, on the traditional ground that tax bills could not suitably be written on the floor of the House. They requested, according to Chairman Doughton, that the rule not be liberalized, but if it were liberalized that it be made possible to offer an amendment to the railroad provision. Representative Slaughter, a member of the Rules Committee who favored the defeated Robertson provision, objected to a "gag" rule. Representative Clarence Brown took up the fight, arguing that within the Ways and Means Committee the division had been close on the question of dating excess-profits tax exemption relief, and he contended that while the bill would give prompt aid to large businesses, it would not do the same "for the little man." Chairman Doughton estimated that it would cost the Treasury $235,000,000 to make the exemption increase retroactive to January 1, 1945. "And this," he added hotly, "would be a straight-out windfall." He pointed out that corporations already had taken the excess-profits tax into consideration in figuring their selling prices, and stated that "this $235,000,000 is already being passed on to the consumer." By thus rendering a decision on the moot question of whether corporation taxes are passed on to wage earners and consumers, Mr. Doughton placed himself ideologically in the camp of his old foe, Mr. Ruml.

Furthermore, Mr. Doughton stated, the increase in the excess-profits tax exemption was the only element in the five-point tax program which

involved a reduction of tax liabilities. To that extent it was a departure from the hold-the-line policy. While there might be good reasons for raising the specific exemption late in the war at a time of widespread reconversion, any relaxation in the hold-the-line policy effective as early as 1945 was "undesirable."

Although members of the Ways and Means Committee, including those who had sought to make excess-profits tax relief retroactive, stood together, the Rules Committee disagreed. It granted a rule under which one amendment might be offered which would set the effective date for the increased excess-profits tax exemption. Thus the decision was left to the House which, on July 5, adopted the rule by a vote of 211 to 131.

During the heated debate on the rule a storm broke around the railroad provision. Mr. Eberharter was reminded of the tax refunds Secretary Mellon had given and how the corporations had "waxed fat and strong." He accused the Rules Committee of refusing to give the House an opportunity to vote on "this luscious melon that is being given to the railroads of the country." Majority Leader John McCormack denounced it as a "nice steal." Mr. Rooney bitterly charged that John Q. Public, "as usual," would have to foot the bill to pay for the "fancy piece of cake" presented to the "hungry" railroads.

On July 6 the House resolved itself into the Committee of the Whole House on the State of the Union to consider the bill. Contending that "there is no time like the present," Mr. Slaughter led a fight to apply the increased excess-profits tax exemption to 1945 taxes. The amendment was defeated 120 to 95. Chairman Doughton, who was supporting the bill as reported by a majority of the Ways and Means Committee, veered from his straight course to charge that in his opinion the committee had not given "fair consideration" or "sufficient study" to the railroad provision. It not only involved an immediate loss of revenue of about $8,500,000, but it was also made retroactive to the years beginning after December 31, 1938. The homespun North Carolinian drove his point home with a story about Jim and his brother who were having lunch one day when the menu carried the item, "Oxtail soup." Reading the bill of fare, Jim's brother dryly commented: "That's going pretty far back on the ox." To the Chairman of the Ways and Means Committee, 1938 was going "pretty far back" in the matter of making

a law retroactive. "It may be perfectly all right, but still, as Jim says, it is going pretty far back." That day the bill, including the railroad provision, passed an unmoved House by a vote of 246 to 91.

Six days later, on July 12, on the motion of the vigilant La Follette, the Senate Finance Committee struck the railroad provisions from the bill "without prejudice" to further consideration. The committee took the position that these provisions were "outside the scope of the purposes" of the bill, and suggested that they be the subject of further consideration and a public hearing. With this change the measure was reported to the Senate on July 19 for action.

An amendment by Senator Wherry to apply the proposed increase in the excess-profits tax exemption to 1945 earnings instead of 1946 income, as provided in the amendment rejected by the House, was voted down 31 to 30. Supporting the Wherry amendment were 23 Republicans and 7 Democrats. Defeating it were 24 Democrats, 6 Republicans and 1 Progressive. After prolonged debate Senator Murdock finally withdrew an amendment permitting labor and other costs incurred in the drilling of oil and gas wells to be deducted from gross income as an expense or charged to capital account.

Senator Johnson of Colorado rose to oppose the action of the majority of the Finance Committee in deleting the railroad reorganization provisions. He thought that since we were going to "stabilize Siam, Abyssinia, Iran, and Iraq, to say nothing of Italy, England, Russia and all the rest of the world," when it came to a little matter of stabilizing railroads in receivership it was too bad to hold back and say, "Nothing doing."

Senator La Follette came to the committee's defense. He denounced the proposal as "class legislation" in that it applied only to railroads, and he further charged that it was "almost individual taxpayer legislation" in that it applied to only a very few railroads. It would provide $8,500,000 of tax relief to five reorganized railroads, of which some $6,000,000 would go to the Wabash Railroad alone. The Senate, he said, should "pause and consider" before it let "this camel's nose under the tent." He was satisfied that if the nose got under the tent, the entire camel would be in by the time the Senate came to another general tax revision, and that would create administrative headaches and inequities among corporations "which will cause us to rue the day when we

rushed into this matter without sufficient knowledge and sufficient facts, and without sufficient time to investigate."

After nearly four hours of debate the Senate passed the tax bill by voice vote on the night of July 19. As passed, the measure was the House bill with the railroad relief provisions stricken out.

The following day, the House, eager to adjourn until autumn, concurred without protest in the Senate action. On August 4, as the President was en route to the United States from the Big Three meeting, the White House announced that he had signed the measure which would aid business enterprises in the next two years by adding approximately $5,500,000,000 to their cash balances.

The Tax Adjustment Act of 1945 increased the specific excess-profits tax exemption from $10,000 to $25,000, effective in 1946. This increase was expected to free 12,000 small corporations from excess-profits tax, leaving only 19,000 large corporations still subject to the tax. The provision was designed to give small business added incentive to re-establish itself during the critical reconversion years. Inasmuch as the income removed from the excess-profits tax base would become subject to the corporation normal tax and surtax, it was estimated that the increase in the specific exemption would result in a net loss of revenue of only about $160,000,000 annually. Because of the repeal of the excess-profits tax in the Revenue Act of 1945, this provision never became effective.

Other provisions of the act advanced the payment of tax refunds to which businesses were entitled under existing law and made additional capital for reconversion and other postwar expenditures more promptly available. Two of these provisions dealt with the postwar credit under the excess-profits tax. Under existing law the excess-profits tax rate was 95 percent. However, a corporation paying the tax received a credit of 10 percent of the tax paid. As much as 40 percent of the 10-percent credit could be used currently for debt retirement, but the remainder was turned into postwar refund bonds, cashable from two to six years after hostilities ceased, the length of time depending upon the year for which the bonds were issued. The Tax Adjustment Act advanced the maturity date of bonds issued for 1942 and 1943 to January 1, 1946, and substituted cash payments for bonds which had been certified, but not yet issued, for these two years. For 1944 and later years, the postwar credit was made currently available, so that

the previous net rate of 85½ percent for the excess-profits tax became the total rate of tax payable. It was estimated that the advance in the maturity date of outstanding bonds would make available to corporations about $1,300,000,000 of refunds on 1942 and 1943 excess-profits tax, and that the current availability of the credit for the tax years 1944 and 1945 would reduce tax payments for those years by about $1,500,000,000.

Another provision of the act accelerated the refunds from the carry-backs of net operating losses and unused excess-profits credits. Under the 1942 Act these refunds could not be made for some time after a loss or unused credit arose. Refund claims could not be made until the close of the year of the loss or unused credit, and no method was provided for payment of claims before they had been audited and reviewed. Consequently, while taxpayers might be certain of receiving their carry-back refunds ultimately, they could never know how long they would have to wait for them after filing their claims. For many taxpayers, facing falling incomes and extraordinary expenditures after the cutback of war production, the refunds would come too late.

The Tax Adjustment Act corrected this defect in the carry-back provisions by making tentative cash refunds available within ninety days after a claim was filed. This procedure involved the refunding of tax before audit, a revolutionary idea in tax administration, but an experiment considered necessary to meet the demands of business in the reconversion period. The act also permitted taxpayers anticipating carry-back refunds arising out of current year operations to postpone payment of a corresponding amount of their taxes currently due on prior year income. The carry-back benefits thus accrued to them almost immediately. The amount of the refunds resulting from the operation of the carry-backs would depend largely upon the future pattern of business earnings, and for this reason was difficult to forecast. It was estimated, however, that the refunds resulting from losses and unused credits for 1945 and 1946 would be about $1,000,000,000.

Refunds resulting from recomputing amortization deductions for war facilities were also speeded up under the Tax Adjustment Act. Under the Second Revenue Act of 1940 a corporation which had built a plant or purchased equipment for war production under a certificate of necessity was permitted to amortize these facilities over five years. If, within that period, the emergency ended or a particular firm's facilities were

certified to be no longer necessary for national defense, the firm might elect to have the amortization deductions recomputed on the basis of the shorter period. Shortening the period would result in additional deductions in returns previously filed, and consequently would give rise to refunds. In the normal course of audit and administration the tax refunds would be spread over many months, with a small part of the payments being made in 1946 and the greater part being made during the years 1947 to 1950. The Tax Adjustment Act made possible the payment of tentative refunds arising from the recomputation of national defense facilities within ninety days, a procedure similar to that used to effect prompt payment of carry-back refund claims. Subsequently, President Truman proclaimed the end of the emergency for war facility amortization as of September 29, 1945. Under this provision of the Tax Adjustment Act, taxpayers could receive large tax refunds from recomputed amortization. It was estimated that nearly $2,000,000,000 of overpayments of tax for the years 1941 through 1945 would be repaid in 1945 and 1946. These refunds would have been available under the law as it stood prior to the adoption of the Tax Adjustment Act, but only at a later date.

The Tax Adjustment Act was a prelude to the end of the war in the Pacific. Military prospects brightened steadily throughout the spring and summer. B-29's roared constantly in the rainy skies of the country which with sudden treachery had attacked sunny Pearl Harbor "on a day which will live in infamy." Island after island fell—sometimes only after bloody combat. Invasion and victory were only a question of time. The end of Japanese sea power came in the last days of July. One badly damaged battleship, 4 derelict carriers, 4 abandoned cruisers, 39 destroyers—6 damaged and 10 without crews—51 submarines and 96 small patrol craft constituted the miserable remnants of an Imperial Navy built to rule the Pacific waves. The Japanese fleet had been literally blown out of the water.

Suddenly invasion became unnecessary. Like a cosmic thunderclap came President Truman's announcement from the U.S.S. *Augusta* on August 6 that the product of two years' work by a scientific coalition operating in various parts of the United States had reached a faraway destination. That destination was close to Tokyo. One bomb, having more power than 20,000 tons of TNT, was hurled on Hiroshima. Three days later the deadly mushroom clouds of still another bomb

trailed over Nagasaki. A new and terrible meaning was given to Prospero's famous words:

> The cloud-capp'd towers, the gorgeous palaces,
> The solemn temples, the great globe itself,
> Yea, all which it inherit, shall dissolve,
> And, like this insubstantial pageant faded,
> Leave not a rack behind . . .

Americans accepted this appalling weapon because it would shorten a bloody war, but they accepted with grave misgiving the frightful slaughter which it wrought and the scientific revolution which it betokened. Its potentialities were beyond anything ever imagined by man. In the sober words of the War Department's Smyth Report, civilization possessed "the means to commit suicide at will." From now on it must be either one world or no world at all.

The bell had tolled for the Japanese. Their will to resist had collapsed. Their industry was strangled and the people were at the point of starvation. The breath-taking unleashing of atomic power overshadowed another major development. On August 8 Russia made her long-expected declaration of war on Japan and a mighty Red Army moved into Manchuria. Utter destruction was more than a proud nation could bear; even fanaticism could not face annihilation. Three years, eight months and three days after Pearl Harbor, with a larger army and a far more powerful air force than it possessed on December 7, 1941, the Japanese Imperial Government reluctantly offered unconditional surrender. The Greater East Asia Co-Prosperity Sphere had gone the way of the dreams of the rulers of Babylon. And a very tired world—sick and exhausted—reached the end of a long martial trail. The wearisome vigil was over. A generation of Americans had kept its rendezvous with destiny.

The defeat of Germany and Japan rang down the curtain on an era and a political pattern. The road back to peace was studded with new political and economic stresses and strains as challenging as war itself. For the world had fought its long way only to an uneasy and insecure peace, which was hardly more than the absence of war. Political turmoil and starvation and the unfathomable problems of reconstruction laid a heavy hand upon Europe. The Middle East was torn with strife. Asia was racked by revolt. In the use of her new power the United

States had not passed beyond the awkward age. But for better or worse peace was in the care of the people. They could keep it only if they wanted to pay the price. That price, said General MacArthur, involved "a spiritual recrudescence and improvement of human character." Out of the knowledge of what war meant must come the understanding of the spirit that was vital if we were to save the flesh.

Chapter 17

BUSINESS GETS A GREEN LIGHT: REVENUE ACT OF 1945

THE American economy was in a period of hesitation in the fall of 1945. The nation faced the hard problem of transition from a war-supported and war-controlled economy—in which governmental expenditures had run to $100,000,000,000 a year, in which 10,000,000 civilian workers had been engaged solely in munitions production, in which 12,000,000 workers had been diverted to the armed forces and would have to be fed back into an economic structure with reduced governmental expenditures—to an economy based on the wholly different needs and the less insistent philosophy of a world at peace. Whether we were to have a prompt and successful shift from war to peace, or a delayed and troubled transition with consequences even worse than the aftermath of World War I, depended upon the ability and willingness of producers to fill with civilian output the gap left by declining government expenditures. This in turn depended upon the ability and willingness of consumers to buy that output. Upon the shoulders of the nation's leaders lay the terrible responsibility of making sure that the war boom was not followed by depression or by a greater boom, and that the productive capacity developed during the war should find the fullest possible outlet. We faced what Secretary of the Treasury Vinson called "the pleasant predicament" of increasing standards of living, maintained during the war with unexpected success, nearly 50 percent to absorb the potentiality of the new economic machine created during the war.

The necessity of replacing purchasing power was urgent. Within a month after Japan's surrender war contracts totaling $35,000,000,000 had been canceled; munitions production had been cut 60 percent. Abrupt curtailment of war production seemed to promise a sharp de-

cline in consumer incomes. More than 1,000,000 war workers were laid off with very short notice or no notice at all. It was variously, although mistakenly, estimated that from 10,000,000 to 12,000,000 workers would be unemployed by the end of 1946. By September most of the large labor unions were pressing for higher wages. In general, the increases asked were designed to offset the reduction in wartime earnings attending the decline in number of hours worked, the elimination of overtime pay, the reclassification of jobs to lower-paying grades, and the lower wage scale of peacetime employment. Management was recalcitrant. By January strikes reached epidemic proportions. Reconversion had a long road to travel.

On September 6 President Truman outlined a bold postwar legislative program, in the longest message to Congress since Theodore Roosevelt presented his first comprehensive view of the nation's problems after he succeeded to the Presidency in 1901. Mr. Truman highlighted his recommendations with a challenge:

> The greatest peacetime industrial activity that we have ever seen . . . can happen . . . if the Congress and the administration move vigorously to deal with the economic problems which peace has created.

Activity on the tax front was the first order of business. As they returned to their desks in September the members of Congress were faced with three basic questions: Should taxes be reduced at all? If so, how much? How should the reduction be distributed? The relish with which they approached their task left no doubt as to the views of most Congressmen on the first of these questions. The debate, thenceforth, would concern itself with the second and third.

The second question was harder to answer. The amount of tax reduction for the postwar period must depend primarily on two factors: the level of Federal expenditures and the level of national income. Tax reduction would be popular in direct proportion to its extent. The collapse of resistance on two fronts had produced major changes in the Federal budgetary picture. Federal expenditures, which had reached their $100,000,000,000 peak in the fiscal year 1945, were estimated at about $66,000,000,000 for 1946. Further reductions presumably might be expected. Business was vocal in its yearning for stimulus through

tax reduction. Thus two sets of reasons furnished welcome arguments for satisfying political desires.

But there was another and less rosy side of the picture. War and its aftermath would necessitate heavy outlays for many months to come. Liquidation of the war machine would take time and would cost billions of dollars. Total expenditures for the first peacetime year promised to be over seven times the amount spent in 1940 and over seventeen times the outlay in 1929 when the Treasury was liquidating the World War I debt as well as meeting current charges. The national debt stood at over $260,000,000,000. With no tax reduction the Treasury estimated that revenues would be about $36,000,000,000 in the fiscal year 1946, if the national income were $130,000,000,000, and the deficit for the year would be over $30,000,000,000. Moreover, inflation still threatened, although the situation appeared to be complicated by simultaneous deflationary forces.

The third question required even more thought. The distribution of tax reduction involved a determination of the kind of national economy we should have in the days ahead. If the national income were to be enhanced, if markets were to be stimulated and job opportunities enlarged, purchasing power would have to be increased at the low end of the income scale, where the preponderance of individual consumers is found. At the same time, productive employment must not be discouraged by unduly heavy taxes on business and high incomes. How to apportion tax reduction so that maximum opportunity would be given to consumption and employment, and maximum incentive would be given to business investment was the perplexing problem.

Taxes, the President had said in his message of September 6, would play a vital role in attaining a prosperous peace. Specifically, Mr. Truman recommended enactment of a transitional tax bill as soon as possible to provide limited tax reductions for 1946. Like the Tax Adjustment Act of 1945, the new bill should aim principally at removing barriers to speedy reconversion and to the expansion of our peacetime economy. "We must reconcile ourselves to the fact that room for tax reduction at this time is limited," Mr. Truman declared. "A total war effort cannot be liquidated overnight." After passage of the transitional bill, the President "hoped" that Congress would carefully consider modernization of the Federal tax structure.

Reactions to the President's message differed. Senator George viewed

it as calling for "a realistic approach" to revenue problems. He construed the tax recommendations as directly in line with his proposals for elimination of the excess-profits tax and the capital stock and declared-value excess-profits taxes, and a 50-percent reduction in taxes on personal incomes. Mr. Knutson found the message in harmony with his recommendation for an "across-the-board" cut of 20 percent in individual income taxes.

On September 26 the Ways and Means Committee eagerly began work on a tax bill. Five days later Secretary Vinson presented his program to the committee. In considering wartime tax repeals the Secretary warned that Congress must take into account falling national income, pay rolls and profits, which would cause a revenue drop of nearly $9,000,000,000—from $41,400,000,000 in 1944 to an estimated $32,500,000,000 in 1946 under existing laws. Tax reduction for 1946 should be designed to afford "maximum aid and stimulus" to reconversion and expansion compatible with revenue needs. A "modest" reduction in taxes could help to guard against deflation, but it must not go "too far." In the Secretary's considered judgment, total reductions should not exceed $5,000,000,000 for 1946. The primary function of this bill should be to remove serious impediments which the tax law might present to "the swift transition from a war economy to a prosperous peacetime era."

Mr. Vinson's program of tax reduction included repeal of the excess-profits tax effective January 1, 1946, with continuation of the carry-backs for one more year. Although the excess-profits tax had raised large amounts of revenue, he pointed out that it had been intended primarily to prevent war profiteering, rather than to provide revenue. By the end of 1945 he thought it would be safe to dispense with the tax as a control measure. Furthermore, he considered the excess-profits tax "too erratic a tax engine to turn loose for even one full year of the postwar period." The Secretary advocated repeal of the 3-percent individual normal tax, effective January 1, 1946. This tax was the successor to the old Victory tax, which would automatically have expired six months after the end of the war. He was opposed to any horizontal reduction in Federal income taxes and specifically opposed to the 20-percent "across-the-board" reduction proposed by Mr. Knutson. He rounded out his program with suggestions for reduction of excise taxes to their 1942 rates, effective July 1, 1946, and retention of

pay-roll tax rates for old-age and survivors insurance at their present 1-percent level, until revision could be made a part of broader action on social security as a whole. Congressional action by November 1 was urgent, he said, both to encourage business to speed reconversion and expansion and to give the Bureau of Internal Revenue time to print and distribute new withholding tables before January 1, 1946.

It was hardly surprising that Mr. Vinson's recommendations were well received. He was the first Secretary of the Treasury since Andrew Mellon to go before Congress with a program of tax reduction. His recommendations for cuts in both corporation and individual taxes motivated a wave of buying in securities markets. The *New York Herald Tribune* considered his changes "generally well-conceived from both a quantitative and qualitative standpoint." Mark Sullivan said his proposals were "a sound beginning."

The Secretary's broad objectives also found immediate favor with the Ways and Means Committee, but the members disagreed on the method of achieving them. On October 9 the committee with almost feverish haste reported its own bill. The measure slightly increased the total $5,000,000,000 tax reduction which the Secretary had said was the utmost we could afford, and distributed the reduction very differently among taxpayers. In the individual income tax field the committee bill applied the surtax exemptions of $500 each for the taxpayer, his wife and each of his dependents to the normal tax, thus doing away with the dual system of exemptions and dropping from the tax rolls 12,000,000 persons at the low end of the income scale. It reduced the surtax rates 4 percentage points in each bracket—making the starting rate for the combined normal tax and surtax 19 percent—and adopted the principle of Mr. Knutson's proposal by giving a 10-percent minimum reduction to all taxpayers. This provision gave additional relief to taxpayers with surtax net incomes above $20,000. The 90-percent limitation on the aggregate normal tax and surtax was cut to 81 percent.

The committee dealt with high-profit corporations more sparingly. Instead of repealing the excess-profits tax outright, effective January 1, 1946, it voted to reduce the net rate to 60 percent for the calendar year 1946 and continue the tax until January 1, 1947. This proposal was first made by Chairman Doughton on the theory that outright repeal would distribute relief unwisely among corporations. It would give considerable relief to 19,000 corporations, but none at all to more than 400,000

other corporations. Continuation of the excess-profits tax through 1946 would automatically make the unused excess-profits credit carry-back available from 1946 to 1944 and 1945, a provision designed to help corporations with difficult reconversion problems. However, the committee instructed its staff to try to develop a way of preventing the abuse of the carry-back, inasmuch as it would be possible for "war babies" to stop operations and claim a refund of past excess-profits tax payments. Few people then realized that within a few months the retention of the carry-back would be strenuously criticized on the ground that it financed resistance to the strikes that were throttling several major industries.

Supplementing the relief afforded to corporations by reducing the excess-profits tax rate, the committee voted to reduce corporate surtax rates 4 percentage points, beginning January 1, 1946, making the combined normal tax and surtax rate on corporations with net income of $50,000 and over 36 percent. The capital stock and declared-value excess-profits taxes, long opposed by the Treasury, were repealed. Further tax cuts were made by reducing wartime excise rates to 1942 levels, effective July 1, 1946, repealing the use tax on automobiles and boats, and freezing the employment taxes to finance old-age and survivors insurance through 1946 at the 1-percent rate.

On October 9 the bill was referred to the Committee of the Whole House on the State of the Union and on October 10 the Rules Committee reported the resolution for a "gag" rule, waiving points of order, allowing committee amendments only which would not be subject to amendment, one motion to recommit, and debate limited to four hours. In presenting the rule for consideration Mr. Sabath, Chairman of the powerful Rules Committee, "relieved himself" by giving expression to his "innermost feelings." In his opinion the Ways and Means Committee had "gone far afield" in reducing excess-profits taxes and other corporation taxes. The reduction of the excess-profits tax was "manifestly unjustifiable and unwarranted because these very corporations have accumulated in the last few years between $26,000,000,000 and $28,000,000,000 . . . after paying all the taxes they have complained about so much." He further objected to the social security tax freeze: "If there has ever been a time, this is the time when employers as well as employees can easily add a little more to the fund for their future welfare." Chairman Doughton rose to his committee's defense. This was

the "fairest and most equitable" tax reduction bill that had been written by the House since he had been a member of the Ways and Means Committee. Excess-profits tax reduction was the "bone of contention" in the bill, but it was "largely a political bone."

Most of the Republicans spent the day cheering the $5,300,000,000 of tax cuts provided in the bill, although many of them were careful to temper their enthusiasm by declaring that the reduction was "not enough." At the same time they repeated their old plea for a balanced budget. They did not explain how these conflicting objectives were to be achieved except by cutting down expenditures, an entirely inadequate method of balancing any conceivable budget in the existing circumstances.

Mr. Knutson, master of Republican ceremonies, recalled that since the New Deal had come into power in 1933 there had been seventeen tax bills, all imposing new and increased burdens in the form of additional taxes. This was the first tax bill in thirteen long years designed to lighten the tax burdens of the American people and, as such, would be hailed with joyous hosannas by the 12,000,000 who would be relieved from paying Federal income taxes. Those who remained "chained in bondage to the Federal tax collector" would experience a feeling of thankfulness in varying degrees. The Republican members stood with the Treasury Department on excess-profits tax repeal as of January 1, 1946. Their reason was brief: the war was over and the tax had served its purpose.

Insurgent Democrats took a different view. It seemed to Mr. Granger that next year "when people would be in a better position to pay than they ever have been before," it was "absolute folly" to take away from tax revenues $5,000,000,000 and then next month go back and sell those people bonds for $11,000,000,000. Mr. Gallagher had interviewed a great many businessmen and "all of them admitted that they were making more money now than they ever did, or more than any class ever did in the history of the country." He believed the corporations and wealthy individuals could afford to pay the taxes they were now paying. While he did not object to this reduction, he did not want "any more of it." Mr. Voorhis considered that the relief in this bill "accorded to people whose incomes afford more than a good standard of living" was "more than can possibly be justified under the present circumstances of our country." And he could not refrain from saying that "it

does not seem right at all to take some hundreds of millions of dollars off the taxes on liquor, as this bill does."

Mr. Bailey pointed out that tax reduction at this time "that does not take into consideration fixed debt charges, an adequate Army and Navy, veterans' care and pensions as well as some assurance of job security and individual purchasing power, in the immediate postwar period, may well be false economy." He was in hearty accord with the committee's desire to give some relief now from our wartime tax burdens, but when he conscientiously, though inaccurately, considered that "24 percent plus of the $5,500,000,000 relief to be granted was going to 19,000 of the nation's 60,000,000 taxpayers and that another 3 percent of the plum was being handed the consumers of liquor, fur coats, and cosmetics," the proposals were indeed "questionable." To his way of thinking, "economically, our nation is still in 'sackcloth and ashes' and will be for years to come."

Mr. Healy said that the measure disregarded some of the most elemental principles of sound taxation, and for that reason should be recommitted for further study. Through the relief granted to corporations, Congress "had created a situation which made it virtually impossible for corporations to suffer from the impacts of reconversion to civilian production." While he conceded that some of this was necessary to bring production to high levels speedily, he thought "great consideration had been shown to the corporations on the one hand and virtually none had been shown to individuals."

Mr. Anderson, a Minnesota Republican, was not in accord with his colleagues. He objected to the tax relief given to individuals in the middle and higher brackets. The Ways and Means Committee was putting great emphasis on the fact that 12,000,000 of our lowest income groups would pay no income tax if this bill passed, "but what did it do for the people in the $10,000 and higher groups?" The $10,000 people got a "nice little reduction of $365 in order to help the poor little fellows get their reductions from $3 to $45 each." The $500,000 man was given an extra $44,645 for his own pocket. He concluded:

> The crocodile tears shed here today for Paul Jones and his $3 and Bill Smith and his $45 must have seared the soul of the gentleman with a present tax of $675,000 on a $750,000 income who mournfully grasps at the additional $67,500 pocket money handed him today. . . . Why must we in order to help Bill Smith, a $2,000 a

> year man, save his $45 which he has been proud to pay toward our nation's upkeep, give our million-dollar-income friend $90,000? These questions have not been answered here today.

Mr. Robsion, another Republican, thought it "passing strange and interesting that we are reducing taxes in this bill." It could be justified only on one ground,

> and that is the encouragement it would bring to private initiative and private enterprise . . . to invest their money, create jobs, and start the wheels of industry going good and strong. . . .

As a climax to a field day of demagoguery, thirteen Democratic members issued a statement saying they were giving the bill "reluctant support" and attacking it as "giving the lion's share of tax forgiveness to those who don't need it." They added, however, that they were "swallowing" it, since it removed "the worst tax provisions which have borne down almost unbearably on the lowest income tax groups." With this timid protest the bill passed the House by a vote of 343 to 10 and was sent to a waiting Senate.

Accusations that the Ways and Means Committee had held "star chamber" sessions, denying interested groups an opportunity to be heard, may have prompted the Senate Finance Committee to hold public hearings for three days beginning October 15. Secretary Vinson renewed the recommendations he had made to the Ways and Means Committee and urged the adoption of his program in preference to the House bill where the two were not in agreement. The House bill was "reasonably close" to his $5,000,000,000 tax reduction limit for 1946, but he pointed out that it would operate to grant reductions of more than $7,000,000,000 for 1947. The Secretary declared that "we should not today prejudge to this extent the tax needs for 1947." The Federal Government was running a large deficit and tax changes should be made "only in those forms and at those points where they would achieve the greatest positive economic good." One of those forms was the excess-profits tax which he considered the "strongest impediment to reconversion." He opposed the 10-percent minimum reduction in the individual income tax adopted by the House on the ground that it would increase the taxpayers' income after taxes much more, proportionately, in the higher than in the lower brackets. Spokesmen for the

National Association of Manufacturers and the United States Chamber of Commerce repeated the age-old argument that further tax cuts would increase business and production. They sought complete and immediate repeal of the excess-profits tax, plus deep cuts in the taxes on corporation income, plus Mr. Knutson's 20-percent horizontal cut in individual income taxes. The Chamber of Commerce representative demanded that the renegotiation statute be repealed retroactively to December 31, 1944.

Chairman George was receptive to the suggestion for a 20-percent across-the-board cut, which he said he had proposed some months ago, but "the administration and Treasury were against that view and they fell on me like a ton of brick." It sounded "silly" to him to talk about stimulating purchasing power by taking off the 3-percent normal tax. "There is not enough purchasing power saved there to start a windmill." Senator Connally objected to the contention that cutting taxes would bring in more revenue. "We hear it every time we have a tax bill, that if you raise taxes you won't get so much money, therefore keep lowering them more and more." Senator Vandenberg remonstrated that "you had better keep something that we can cut." Senator Gerry wondered if all reductions of taxes weren't highly inflationary at this time. Senator Millikin found it hard "to figure the repeal of the excess-profits tax with the large number of people who have labored under the high taxes we have put on." He cited a tried political precept: "We have to think about what will be accepted."

The Finance Committee reported a bill to the Senate on October 23. The committee concurred with the House in making the individual surtax exemptions applicable to the normal tax, but reduced the surtax rates by 3 rather than 4 percentage points, as the House had done, and allowed an additional over-all straight cut of 5 percent of the tax liability computed under the new rates. Secretary Vinson's recommendation for repeal of the excess-profits tax, effective January 1, 1946, was adopted, and the two-year carry-back of unused excess-profits credits was retained for a year beyond the repeal of the excess-profits tax. A special schedule which reduced the combined normal tax and surtax rates on corporations with incomes up to $60,000 was provided, but the basic rate was retained at 40 percent.

The Finance Committee concurred with the House on repeal of the capital stock and declared-value excess-profits taxes and the use tax on

motor vehicles and boats, but made no change in existing law on the termination date for wartime excise taxes. The Finance Committee bill also made special tax concessions to veterans and servicemen.

Even tax reduction is a thorny subject. On October 24 the Coordinating Committee for a Progressive Tax Program, composed of the C.I.O. and fourteen other labor, consumer, professional and church organizations, assailed the Senate bill as a measure "to relieve 99,000 wealthiest corporations and individuals." On the same day the bill was debated in the Senate. Senator O'Mahoney was "appalled" at the pending measure, which undertook to make a reduction in the tax revenue "almost as great as the amount of the interest the government would have to pay next year on the national debt." We were "blindfolding ourselves" to the "gravity of the whole situation." The country was facing inflation. It was re-enacting the history of the period following World War I.

> Never were the people better prepared to bear taxes than they are now. Never was capitalism in greater danger than now. Never was there a more inappropriate time to cut taxes.

A motion by Senator Connally to reduce rather than repeal the excess-profits tax was rejected. The Texan admitted that he might be "an extremist," but he believed the excess-profits tax was "a permanently sound tax." It might contain many inequalities, but there were inequalities in practically all tax laws. "The reply was not just to repeal it; the reply was to perfect and amend it." Senator O'Mahoney agreed. Senator George deplored the turn the debate was taking. He wanted to eliminate the excess-profits tax because he desired "the young men of this country to have a chance to engage in business enterprises."

Senator Connally was for free enterprise, but he wanted "a little free enterprise in favor of the government as well as individuals." He moved to recommit the bill to the Finance Committee with instructions to report it back with the recommendation that the Senate agree to the House provision relating to the excess-profits tax. This motion was also defeated. With an amendment by Senator Vandenberg giving $85,000,000 of tax relief to small corporations by increasing the excess-profits tax exemption retroactively to January 1, 1945, the "quickie" tax bill passed.

Two days later Senator Fulbright, who had been absent during the debate, made a few thoughtful observations on the Senate floor "to clarify my position about the bill." With Senators Connally and O'Mahoney he strongly disapproved the principal features of the measure. In the opinion of the bright young Senator from Arkansas, the underlying reasons for high wartime taxes applied with equal or even greater force during the critical reconversion period. We faced a heavily unbalanced budget; demands upon our economy would continue for an indefinite period to be greatly in excess of supply. Like Marriner Eccles, he believed that profits to be made in the next year, at least, would be a direct result of war expenditures and thus "just as much war profits as if they were derived while hostilities were still in progress." Taxation was the "last real bulwark against inflationary forces" because of the weakening or removal of other controls. The "most prudent course" at this juncture would be to defer tax reduction until supply was more nearly in balance with demand and we had begun to approach a balanced budget.

If any reductions were to be made at this stage, the Senator thought they should benefit primarily those at the bottom of the income scale, not those individuals and corporations best able to pay. Repeal of the excess-profits tax, in particular, not only would favor the few and the financially strongest corporations, but would grant them benefits, including refunds, at the government's expense, when revenue was of critical importance. It would set an example in pocketing what were, in fact, war profits that would make it difficult to argue that labor should be denied correspondingly large wage increases; and the effect would be to invite the familiar wage-price upward spiral.

Senator Fulbright found the argument that business needs a special tax incentive to produce and employ people at this time "inconsistent" with the basic economic facts. The war had demonstrated that if business had orders it would go ahead producing and furnishing employment notwithstanding high taxes. Business had never had such a peacetime prospect for orders as it had today because demands were so large and so far in excess of supply. With such intense demand and the sharp competition for markets, production would go ahead if there were no reduction in the excess-profits tax. Only if it were carried over as a permanent part of the tax structure and at high rates, could the excess-profits tax be considered a deterrent to new and small enter-

prises, "because it usually took years at best for them to make earnings that would be subject to such a tax."

The observations of the former Rhodes scholar and university president, made too late to affect the decision of the Senate, elicited no response from the conferees who reconciled their differences with surprising speed by resorting to the simple expedient of accepting practically all of the tax reductions in both bills. The House conferees agreed to the Senate proposal for outright repeal of the excess-profits tax January 1, 1946, and the continuation of the carry-back of unused excess-profits credits for another year. As a counterconcession, the Senate conferees consented to reductions in the corporation income tax to a basic rate of 38 percent—exactly twice the rate in 1939. The net result was a much greater reduction in corporate tax liabilities during 1946 than the Secretary of the Treasury had requested. These cuts, amounting to more than $3,000,000,000, added to $2,600,000,000 of reductions in individual income taxes cut down tax liabilities by nearly $6,000,000,000 during 1946.

Both Houses approved the compromise in a revival of nostalgic enthusiasm for the Andrew Mellon economics of the twenties, with member after member recalling those glorious days of normalcy when taxes were reduced and the budget was balanced. No one discussed the simple arithmetic of combining tax cuts with a balanced budget. No one pointed out that the Mellon era ended in the greatest economic crash in American history—a depression that lasted until World War II.

Democrats and Republicans defended their tax slashing by forecasting that it would encourage business and result in increased revenue. The only protest came from Chairman Cannon of the House Appropriations Committee who grimly insisted that the cut would "contribute to inflation" and "postpone indefinitely the day the national budget would be balanced." To this bleak prediction Mr. Knutson gaily replied:

> How sweet it is to hear the watch dog bay
> As we draw near to Election Day.

Chairman Doughton wound up the proceedings by pronouncing his own benediction:

> We have given business a green light. They claimed that what they need is encouragement. Now if they don't go forward, the responsibility is on them.

On November 8, 1945, President Truman signed the measure which Senator George and Senator Taft conceded made a larger reduction in taxes than they would like to see. The individual normal tax was retained in name but, in effect, the old normal tax was eliminated. This was accomplished by increasing the normal tax exemptions to the $500 per capita amount allowed for the surtax and at the same time reducing individual surtax rates 3 percentage points in each bracket. In addition, individuals were granted a further income tax reduction of 5 percent of the tax bill computed at the new rates.

The excess-profits tax was repealed as of January 1, 1946. The two-year carry-back of unused excess-profits credits was continued until January 1, 1947. The corporation income tax was reduced 4 percentage points for corporations with net incomes of less than $25,000 and 2 percentage points for corporations with net incomes in excess of $50,000. The capital stock tax was repealed for years ending after June 30, 1945, and the declared-value excess-profits tax was repealed for years ending after June 30, 1946.

Service men and veterans were given special treatment. Members of the armed forces below the grade of commissioned officer were exempted from tax liability on their service pay received during the war. Commissioned officers were granted an additional three years to pay their taxes on service pay for the war period, with the tax payable in twelve quarterly installments without interest. A similar extension was provided for payment of the tax on preservice earned income for the years 1940 and 1941 which fell due after the serviceman entered the service.

The reduction date for war excise tax rates was kept at six months after the termination of hostilities. The use tax on motor vehicles and boats was repealed as of June 30, 1946.

Finally, the automatic increase in the rates of social security taxes for old-age and survivors insurance, which had been annually postponed since 1942, was delayed for another year, pending a Congressional study of the social security system and its financing.

Book Two

PROBLEMS OF FUTURE TAX POLICY

Chapter 18

WHERE CAN TAXES TAKE US FROM HERE?

So FAR we have dealt with the past of the American tax system. As a practical matter it is vital to search the past candidly to find the errors we should avoid repeating, and to draw together all the threads of political and economic wisdom which we can weave into a useful pattern for the future. It is possible that we stand at the very entrance of a land of great promise. The American people are in a mood of shifting outlook. At such a moment they may rise to the greatness of their unique opportunity. The flood tide that leads to fortune is in the affairs of nations as well as men. But flood tides turn to ebb tides in time, and opportunities may be lost. They do not always return to the same nation.

Our opportunity is not plenary. Today we hardly have the luxurious freedom of starting over again and building a tax system from the ground up. There is rarely a wholly new chapter in history. As a matter of fact, our existing system deserves a better fate than the scrap heap. Although it is far from perfect, even the devil should have his due. A token of respect, if not tribute, should be paid to a tax system which at its peak extracted $46,000,000,000 annually from the American people with no bloodshed. Somehow the system we have has done *a* job, if not *the* job it might have done.

On the other hand, our inherited tax structure has grown piecemeal over the years. It is like a house which has lost architectural symmetry through the random addition of countless extra rooms and wings. But its defects are even more patent and dangerous. The pressures of the postwar world will be too great for its precarious foundations. If our tax system is to serve the needs of a world very different from the one in which it came into being, isolated improvements will not suffice. What

we need is a complete and uninhibited modernization done with a spirit that is brave and minds that are bold.

Over the years our taxes have been the product of the times which brought them into being. We have not permitted the converse to be true; we have never consciously attempted, on a broad scale, to reverse the process and make our times the product of our taxes. In this situation we might profit from Abraham Lincoln's counsel: "If we could first know where we are and whither we are tending, we could better judge what to do and how to do it." So far tax life has been a hand-to-mouth affair. Almost every revenue measure has been little more than a hasty response to an immediate emergency. Rarely have we tried to anticipate emergencies. We probably deserve the taxes we have; in fact, it is remarkable that our taxes are not worse than they are. Bad as they are, they could be worse; good as they are, they could be very much better.

In the future we can have good times in some considerable part as the consequence of good taxes and sound fiscal policy, if we are ready to accept this new order of cause and effect, if we are ready to realize the enormous social and economic potentialities of taxes, and if we are ready to plan and construct a tax and fiscal system that will help to produce the kind of world we want.

There are auspicious signs that we are developing a new approach to taxation. If there is a goddess of history she should have some reason for looking down on the developments of today with hope. More and more people are beginning to recognize the need for long-term planning, the tremendous effect of taxes upon employment and national income, and the prodigious amount of hard work required to build a tax system that will help to make a secure and stable American economy. They are coming to see that the only system which will adequately serve our future needs cannot be picked out of thin air, or concocted in dreamy ivory towers, or hastily improvised on legislative floors in response to immediate economic demands. It must rather be a realistic long-term program which is part and parcel of a desired future social and economic fabric for the nation.

Too often in the past we have put last things first. We have been disposed at the outset merely to ask how much revenue should be raised. But this is an ultimate question. This time, as we face the challenge of an unfathomable future, we shall do well to begin at the

beginning and put first things first. The first order of business will be an appraisal of the controlling facts. The second step will be the development of a basic policy designed in recognition of those facts to achieve the ends we desire.

The facts are not all discoverable now. We cannot know some of them until the shapes of presently confused international relationships become fixed and clear. But contours do become less blurred as the months go by. We know that postwar governmental expenditures are certain to level off at heights many times above those of the prewar period. We can now at least reasonably hope for a greatly expanded scale of living. Our capacity to produce has reached proportions that none but a few dreamers suspected before the war. The people have had prosperity within their grasp, and it will be strange if they are content in the future with baser coin. We know that we shall have to do a better job than we have ever done before if we would hold the progress of an astonishing era, and if we would make victory in the costliest war of history worth the sacrifices with which it was bought.

This time we shall perhaps realize that questions of tax policy go deeper than revenue considerations alone. We dare not think so superficially in the days ahead as in the decades before the war; the compulsion to get down to fundamentals is overwhelming. We shall have to discard many of the tax traditions of prewar days, and unlearn much before we learn even a little. But we shall have to do more than that. We must fulfill as well as destroy. We shall have to think anew and act anew. We shall have to develop a philosophy of taxation, tuned to the mood of a world far different from the one we knew in prewar days.

If we would have a tax system which realizes its functional potentialities, if we would use taxes not only to raise revenue but also to achieve social and economic results, purposeful thinking will start with the question: What kind of a world do we want? The outlines of that world need not be sharp and precise; every detail need not be envisioned. But we must settle on a general pattern if we would plan our taxes intelligently.

Our basic choice will lie between the known and the unknown, between the kind of social and economic order we had before the war and a better order reshaped to fit a new design for living. Underlying much rationalization in the postwar tax debate will be a powerful nostalgia to settle back among the old familiar things to which we

were once accustomed. A new kind of world will require changing age-old concepts and social relationships that we once held sacred and immutable. To discard old attitudes and habits will be painful. To devise new attitudes and habits, based on a correct perception of the realities of a new day, will be difficult. Adjustment will be a strain, especially to those who were comfortable in the old world. We know that the "cake of custom" is the greatest bane of improvement. Institutions become fixed in a mold, interests are built up around the *status quo*, and mental inflexibility imposes its own barrier to change. Some people will contend that it is better to accept the acknowledged ills of the world we have had—a reasonable amount of unemployment, violent ebbs and flows of the business cycle, inadequate social security, a low standard of national health and deficient housing—than to fly to others we know not of. Of course the argument will not always be put so bluntly. Deceptive catchwords and seductive clichés will be marshaled to camouflage the issues, and we shall continue to hear much incantation about "free enterprise" and the "American way of life." Just as in 1895, some of those who speak out for a higher standard of living for the many will be denounced as socialists and communists.

Much of the opposition to proposals for change will come from groups who believe they will be adversely affected in a financial way. Those who listen to this stubborn resistance may come to despair of any hope of progress until we evolve a better human race. Some of those who want a different world will be pooh-poohed as dreamers. But this last accusation will not be as convincing as it might have been a few years ago. The war gave a new validity to dreams. A great experiment was made. It was not consciously made, but its meaning is nonetheless clear. We tried full employment because the war forced it upon us. Millions of workers and their families know now that financial skies do not fall when the economy runs at full blast; and millions of returned soldiers and sailors, who risked their lives while others profited much, want their chance to prosper in an economy they have saved. Their absorbing interest is in continuing jobs, bank accounts, better homes and a world in which they can live with dignity. They demand these things because they gave their sweat and blood for them, and not for something less.

There is no lack of tax plans for the postwar period. Glib answers are being offered on every hand, some by those who do not think

clearly and some by those who think only too clearly of themselves. To separate the good from the bad will require ruthless objectivity. The solutions inspired by special interests will not develop a sound postwar tax system. Nor will undue emphasis upon the immediate desires of a particular community, or group in society, or industry or unit in industry, give us what we imperatively need. No argument should be deprived of its day in court. But the end product must be fair to all interests and to all groups. And it must reflect more than equity; it must express a philosophy which fits into the making of a world that suits the mood of the American people. No other tax system will do the vast job ahead. For the pressures of the postwar world upon our tax system will be greater than they have ever been—even in wartime. In wartime there was a quiet tug of restraint; the still small voice of patriotism developed in many people a sense of tax responsibility. The return of peace has dulled that sense and brought with it a growing appetite for special favors. To develop a system that can withstand this strain is the task and opportunity of the American people—today, and tomorrow and for many days to come.

It would have been impractical to redesign our tax system while we were fighting a war. A basic revision job cannot be done when rates are rising in a sensational way. The time factor is also against a fundamental approach when total war is rending the whole economic and social fabric of the nation and affecting almost every item in the daily life of every citizen. Under such circumstances Congressional attention is necessarily focused upon many issues which vie in importance with taxes. It is remarkable that so much revision was accomplished in 1942 and that current tax payment was achieved in 1943. But throughout the war we ventured into no completely new tax territory.

The postwar period presents the ideal opportunity for tax revision. We shall have time and an increasing margin for necessary trial and error. Our vision will have a chance to penetrate further some of the obscurities and dilemmas that face us. As we move along, we can indulge in experiments with the assurance that we may correct our mistakes later. We need not experiment recklessly, but there will be room for some play of economic and social innovation. Of course we may not indefinitely postpone our search for further knowledge, nor will we have an unlimited period for experimentation. For there remains the vital necessity that our tax system be promptly recon-

stituted as a part of an integrated economic and social program. This is a "must" if we expect a prosperous survival of the kind of civilization which has just been saved in the bloodiest combat in history. The word "prosperous" is probably tautological. There may well be no survival, which is other than prosperous, of the civilization most of us have grown to feel best fits the American spirit and the American continent.

Chapter 19

BOUNDARIES OF TAXATION

No matter what kind of tax structure we attempt to build for the future, we shall find ourselves confined within definite bounds. The sources of governmental revenue are limited. The whole world has been able to think of only a few groups of taxes and generally has chosen to resort to the same few. They are (1) individual income taxes; (2) corporation taxes; (3) turnover, sales or excise taxes; (4) estate or inheritance taxes; (5) other privilege taxes, including various types of business taxes; (6) customs duties; and (7) diverse kinds of taxes on ownership of property, such as the general property tax, taxes on land and intangible wealth, and the capital levy. Because this last group of taxes is put out of the reach of the Federal Government by the Constitutional provision requiring apportionment of direct taxes among the states according to population, the imposition of property taxes is left to state and local governments.

In the greatest of wars, with revenue pressures at new highs, and with an unprecedented necessity of controlling inflation, only three additional forms of taxation were seriously suggested for our Federal system. They were a sales tax, an individual excess-profits tax and a spendings tax. Congress staunchly refused to resort to a general sales tax, the tax on increases of income never came to a vote and the untried spendings tax was rejected by the Senate Finance Committee. In a sense, these were not new taxes. In 1943 the sales tax was employed in twenty-three states and two cities. The individual excess-profits tax was a species of income tax. The spendings tax was a variant of the sales tax, but it avoided the inequities, the inflationary aspects and some administrative stumbling blocks of the sales tax. A few other taxes, such as a tax on gains from wartime speculation and a tax on idle bank balances, never secured strong backing. A tax on capital, feared spasmodically in

rumor circles, was not considered by any responsible government official.

Recently incentive taxation has come in for its share of discussion. But much of the talk has generated more heat than light. Of course, in the broadest sense of the term any use of taxes for purposes beyond the revenue is incentive taxation. Apart from eliminating duplication in individual and corporation taxes, proposals in the incentive area are vague. To the extent that they take definite form, they consist of no more than peripheral modifications of our existing structure, such as a longer carry-over of losses, accelerated depreciation, the exemption of reinvested profits of small corporations and some far less worthy measures. Incentive tax proposals often overlook the problem of distribution of the tax burden, and take credit for stimulations to the economy that may be attributable to deficit financing. Moreover, great care must be taken to limit with fine precision even those incentive proposals which have such meritorious purposes as the expansion of production and employment, so that they may not be used as vehicles for avoidance rather than for the desirable purposes intended. It may be that some valuable tax incentives can be developed, but we need to subject every proposal to close scrutiny. Upon careful examination a promised panacea may turn out to be nothing more than an undesirable subsidy.

As is the case with incentive proposals, there is a sense in which discussion of our future tax structure will deal more with the shadow than the substance. In this sense there will be a reorganization of the tax structure, but not a tax revolution. The problem is one of emphasis. It is unlikely that we shall discard any one of our existing systems. Individual income taxes are here to stay, and more importantly than before the war. Some excises will go, but we shall doubtless retain an excise tax system. We shall probably keep some kind of a corporation tax system. Estate and gift taxes will remain with us; very likely they should be broadened and increased. We may hardly expect that customs duties will be abandoned.

Because we must do our tax job with the tools at hand, it does not follow that the choices we now make are unimportant. No choice will also be a choice. The tax questions which lie immediately ahead and which appear in dim outline on the more distant horizon are among the most serious problems before us. We may muddle through with-

out wisdom, but the safer procedure will be to plan our tax future upon the basis of a careful advance examination of the economic effects of the taxes we impose.

What is required is that we build a tax system which is intelligently directed toward creating and maintaining the kind of world we want. The basic struggle hinges on our choice of worlds. The later, and more technical, struggle is concerned with means to the desired end, that is, the specific taxes we select. The battleground of conflict will not always be sharply delineated. The critics of particular taxes frequently say one thing and mean another. The real objection to a tax may be that it tends to produce the kind of economic or social order which its opponent does not want. But the critic does not always speak out in such ultimate and candid terms. He pleads that the tax will not produce revenue, or cannot be administered or that taxes should not be used to promote social and economic results. Even while his objection is premised on fear that a particular tax will have unwanted social and economic consequences, he may deprecate the notion that taxes can produce such effects. But we need not let our thinking be confused across levels. The fundamental question is always the kind of world we want; our choice of taxes is always a selection of means to that end.

Chapter 20

WHAT DOES THE CONSTITUTION SAY?

IF OUR future Federal taxes are to be chosen in the light of the kind of social and economic results we wish to achieve, an initial question is whether we are free under the Constitution to use taxes for these purposes. Or does the Constitution require that taxes be imposed for revenue only? The answer lies, first, in the language of the Constitution and, second, in the interpretation given to that language by the highest court in the land.

The Constitution is the original document from which all Federal laws derive their authority. By it the people bestow upon the Federal Government the power to tax—the one great power which, in Mr. Justice Peckham's words, is "as necessary to the existence and prosperity of a nation as is the air he breathes to the natural man."[1] But this power upon which our whole national fabric is based is not absolute. It has limitations which have often stirred deep controversy.

To Congress the Constitution gives the power to lay and collect taxes, duties, imposts and excises in order to pay the debts and provide for the common defense and general welfare of the United States. (Article I, Section 8, Clause 1.) The constitutional restraints on that power are that all duties, imposts and excises shall be uniform throughout the United States (*Ibid.*); that no capitation or other direct tax shall be laid unless in proportion to the census (Article I, Section 9, Clause 4); and that no tax or duty can be laid on articles exported from any state (Article I, Section 9, Clause 5). Direct taxes must be apportioned, while indirect taxes must be uniform throughout the United States (Article I, Section 2, Clause 3). The Constitution precludes the states from laying imposts or duties on imports or exports without the

[1] Nicol *v.* Ames, 173 U. S. 509 (1899).

consent of Congress (Article I, Section 10, Clause 2). It further requires that all bills for raising revenue shall originate in the House of Representatives, but the Senate may propose or concur with amendments, as on other bills (Article I, Section 7, Clause 1.)

Three amendments affecting taxes have been added to the original Constitution. The Fifth Amendment, which, unlike the Fourteenth, has no equal protection clause, provides that no person shall be deprived of life, liberty or property, without due process of law. The Tenth Amendment reserves to the states, or to the people, the powers not delegated to the United States by the Constitution. The famous Sixteenth Amendment gives Congress the power to lay and collect income taxes without apportionment, thus to all practical purposes eliminating the principal applicability of Article I, Section 2, Clause 3, of the original Constitution.

Even today, after a century and a half, no one can define the term "direct" tax, as it used in Article I, Section 2, Clause 3, of the Constitution. Rufus King asked for the precise meaning of the term at the Constitutional Convention. There sat Madison and Hamilton and Martin and Pinckney and all the rest of the great lawyers of that day, but no one answered. In 1796 Alexander Hamilton was paid $500 for persuading the Supreme Court[1] that a duty on carriages was not a direct tax; he contended that the term included only capitation or poll taxes, taxes on land and buildings and general assessments. At that time Chancellor James Kent, a prominent New York jurist, spoke of the "better opinion" as including only the first two of these taxes. In the nineteenth century Mr. Justice Story divided all taxes into two classes—direct taxes and indirect taxes; he included taxes upon land in the former class, and taxes upon consumption in the latter. A Civil War income tax was held constitutional without apportionment as an excise or duty.[2] But in 1895 a different court in the Pollock case thought the tax on income from land was a direct tax so that it could not be imposed without apportionment. Thus the 1880 decision was reversed within a generation and the Sixteenth Amendment became necessary if the country were to obtain revenue from income taxation.

From the constitutional viewpoint the income tax has been treated

[1] Hylton *v.* United States, 3 Dallas 171 (1796).
[2] Springer *v.* United States, 102 U. S. 586 (1880).

with remarkable kindness since the 1913 Act was upheld.[1] There have been some setbacks, such as the 5 to 4 decision of 1920, holding that stock dividends were not income within the meaning of the Sixteenth Amendment,[2] and the decision,[3] later overruled,[4] forbidding a tax upon the salaries of Federal judges. The Supreme Court has made it clear that it is constitutional for the Federal Government to tax salaries paid by the states,[5] just as the states may tax salaries paid by the Federal Government,[6] and there is little doubt that the present court would sanction the taxation by the Federal Government of interest on state bonds.[7]

Excise taxation has had fewer constitutional handicaps than income taxation. Here the principal constitutional requirement is uniformity. But this is not a rigid formula. It is now well established that the uniformity exacted by the Constitution is geographical, not intrinsic, which means merely that the liability shall be the same throughout all parts of the United States. Arbitrary classifications are forbidden, but questions of policy and practical convenience are to be considered in determining what is arbitrary. Attacks based upon the Fifth Amendment have at times been successful, sometimes against distinguished dissents, principally where retroactivity was attempted.[8] In one case, Heiner *v.* Donnan,[9] the Supreme Court held unconstitutional a conclusive presumption that gifts within two years of death were made in contemplation of death so that the property given was subject to the estate tax. But two of the ablest members of the court dissented, and it is doubtful whether the "reconstituted" court would come to the same conclusion. To declare a statute unconstitutional is a heroic remedy and the gravest and most delicate duty the Supreme Court is called upon to perform. Constitutional questions are, after all, questions of degree upon which reasonable men may differ widely as to where the critical line should fall. But it seems logical that doubt as to constitutionality should end

[1] Brushaber *v.* Union Pacific R. R. Co., 240 U. S. 1 (1916).

[2] Eisner *v.* Macomber, 252 U. S. 189 (1920).

[3] Evans *v.* Gore, 253 U. S. 245 (1920).

[4] O'Malley *v.* Woodrough, 307 U. S. 277 (1939).

[5] Helvering *v.* Gerhardt, 304 U. S. 405 (1938).

[6] Graves *v.* New York ex rel O'Keefe, 306 U. S. 466 (1939).

[7] New York *v.* United States, 326 U. S. 572 (1946).

[8] Blodgett *v.* Holden, 275 U. S. 142 (1927) modified 276 U. S. 594 (1928); Undermyer *v.* Anderson, 276 U. S. 440 (1928).

[9] 285 U. S. 312 (1932).

if the line of the statute falls at a point where, in the opinion of the court, reasonable men would not be able to say with conviction that the Constitution had been violated.

A pedantic view of the Constitution often warps the process of statutory interpretation. Even Mr. Justice Holmes has been known to construe a statute in such a way as to avoid "serious" questions of old-fashioned constitutionality.[1] This is to some extent a question-begging technique, inasmuch as it is the duty of the courts to meet the issue not on the basis of serious possibilities, but at the point of final decision. There is a cogent argument against statutory interpretation which too highly respects doubts as to constitutionality; Congress may have intended to go to the limits of its power under the Constitution as it is currently interpreted, and an ungenerous construction of a statute in the light of restrictions of another day may thwart that intent. Statutes are presumed to be constitutional. Surely that presumption should not be lightly overturned by speculative assertions that a given construction might be unconstitutional.

The Constitution still stands as an impediment to much legislation that we need. When the proposal was made in 1942 to tax income from state bonds, some legislators objected because such a provision might be unconstitutional. Here again we have avoidance of responsibility. It is for the courts, not Congress, to decide whether an act is constitutional; as President Franklin D. Roosevelt once pleaded, the legislature should do as it pleases within reason. Respect for the Constitution, like patriotism, may otherwise become camouflage for motives of a far less worthy character.

One need not accept as gospel Dr. Thomas Reed Powell's cavalier remark of 1920 that "the constitutional aspects of Federal income taxation are unimportant," but the truth is that Congress, as never before in this country, is free to enact the tax laws it deems in the interests of the nation. Former Chief Justice Hughes once said that the Constitution means what the Supreme Court says it means. This statement should not be cynically interpreted. Constitutional language is deliberately comprehensive, for the Constitution is a great charter of government. It is dynamic, not static, and may grow in meaning as new conditions in a chaotic modern world develop new needs and crises. In that sense the Constitution is not dead, as Mr. Justice Mc-

[1] Lewellyn *v.* Frick, 268 U. S. 238 (1925).

Reynolds dramatically proclaimed in announcing his dissent in the famous "gold-clause" case, but has had a rebirth of freedom.

Constitutional victories for taxpayers in the tax field in the days of the old, as well as the new, court are noted for their rarity. With the possible exception of the stock dividend decision, there has been no major victory since the Pollock decision in 1895. It is true that in a penumbral area the Constitution needed some reinterpretation; the old interpretation of the Sixteenth Amendment halted for nearly two decades the development of an income tax system. In the estate tax field the interpretation sometimes given to the versatile Fifth Amendment has to its discredit a quota of damage in terms of the construction or elimination of needful provisions. But over the whole area the apathy of the people more than the Constitution and its interpretation has been responsible for our tax backwardness.

Speaking more broadly, until recently, constitutional issues were frequently overmagnified and some reaction was inevitable. The Constitution was sometimes badly construed, and the Supreme Court is now putting constitutional restraints at a much more remote point. It is easy at such a time to lose perspective and to think that all restraints are gone. It would be more accurate to think that the reconstituted Supreme Court is chloroforming some of the old rabbits which previous courts had pulled out of the constitutional hat. We have a reinterpreted Constitution, not no constitution at all.

Constitutional eyebrows have sometimes been lifted at the suggestion of taxes for other than revenue purposes. But for decades tariff acts have been framed not only to raise revenue, but also to encourage the industries of the United States.[1] True, the Supreme Court of a former day held the child labor tax unconstitutional on the ground that the word "tax" should not be given such magic as would enable it "to break down all constitutional limitation of the powers of Congress and completely wipe out the sovereignty of the states."[2] And as late as 1936 a majority of the Supreme Court, in holding the Agricultural Adjustment Act unconstitutional, said that Congress, having no direct power to enforce its commands on the farmer to the ends sought, could not indirectly accomplish these ends by taxing and spending to purchase compliance.

[1] J. W. Hampton, Jr, & Co. *v.* United States, 276 U. S. 394 (1928).

[2] Child Labor Tax Case, 259 U. S. 20, 38 (1922).

A year later the shadow of state sovereignty failed to darken a majority opinion[1] written by Mr. Justice Stone, who had dissented from Mr. Justice Roberts' opinion in the AAA case. A defendant convicted of selling firearms without payment of a prohibitive tax could not convince the court that the tax was "not a true tax, but a penalty imposed for the purpose of suppressing traffic in a certain noxious type of firearms, the local regulation of which is reserved to the state because not granted to the National Government." How could the court know? The tax produced some revenue; the court was not "free to speculate as to the motives which moved Congress" to impose the so-called tax. Inquiry into "the hidden motives" which might move Congress to exercise a power constitutionally conferred upon Congress was "beyond the competency of courts." There may be a touch of fiction in this type of argument, but the Supreme Court must occasionally secure unanimity by indirection. A given objective at the end of a straight path may sometimes be reached by following a devious route.

Later decisions of the Supreme Court, including the social security cases, steer a careful course in the direction of freedom from constitutional inhibitions. Legislative draftsmen have learned to preserve silence as to ulterior motives beyond tax territory, and the court has learned how to shut its eyes to things it does not care to see. Ostrich-playing of this type could be unfavorably compared to the brand of jurisprudence which Bentham condemned as "the art of being methodically ignorant of what everyone knows." But courts must occasionally bow to their own inhibitions, and one must sometimes read between the lines of opinions. The inner lesson may be that the propriety of the motives which produced much current legislation is essentially a "political question" (using "political" in an Aristotelian rather than an invidious sense) into which the judiciary should hesitate to trespass.

[1] Sonzinsky *v.* United States, 300 U. S. 506 (1937).

Chapter 21

TAXES FOR MORE THAN REVENUE

IF WE are to make wise tax choices in this critical period of our history, we must begin with sound premises. Moreover, as Mr. Justice Frankfurter has wisely said, "The right answer usually depends on putting the right question." Answers will be hard enough without the handicap of false premises and loaded questions.

Why do we have a Federal tax system? In answering this question we shall do well to break with tradition and think with open minds. The first item of business is to reject the gospel that taxes are for revenue only. This notion is contradicted by our history and is one of the most dangerous assumptions we could make. Any tax that produces revenue will in some way alter the social and economic order. Once we recognize that a "pure tax" is a figment of the imagination, we can see the true purpose of taxation, as one of the most powerful instruments for influencing the social and economic life of the nation. In this country at least, the purpose of taxes is not limited to raising the money the government needs to spend. American statesmen have employed taxation with incidental, or even dominant, nonfiscal motives ever since the day of Hamilton's *Report on Manufactures*. Jefferson urged inheritance taxes to promote small proprietorships. Thomas Paine saw in death taxes a way to finance old-age pensions and grants to youth. In the twentieth century taxation began to assume a mounting share in the process of social adjustment.

Some taxes have no revenue-raising purposes whatever; for example, the Federal and state taxes on oleomargarine. Other taxes have multiple functions. The heavy excise tax on liquor is intended as a measure of social discipline as well as a source of revenue. The Federal estate tax has the purpose of raising revenue, but its modern origin in the United States can easily be traced back to agitation in the early part of the

present century for the limitation of inheritances. This movement was supported by Theodore Roosevelt and Andrew Carnegie. Former Vice-President Garner, speaking in the House of Representatives in 1924, said that "one purpose of an inheritance or an estate tax is to encourage the distribution of large estates." A number of years later, in 1932, Congressman LaGuardia referred to an increase of the Federal estate tax as being "in keeping . . . with the policy not only to raise needed revenue," but also "to establish social legislation which will eventually prevent the concentration of wealth of the nation into the hands of a few families." President Roosevelt's message to Congress on tax revision on June 19, 1935, vividly presented the same viewpoint. The gift tax is more a "policeman" than a revenue collector. The corporation income tax is highly important in terms of revenue, but it also has provisions designed to encourage corporations to distribute dividends and to refrain from accumulating surplus beyond the "reasonable needs" of their business. The excess-profits tax of World War II, like that of World War I, yielded considerable revenue, but it was not imposed for that single purpose. This tax, together with the renegotiation statute, was meant to prevent extortionate war profiteering by a few at the expense of the many, and to solidify the morale of labor and the armed forces. These statutes would doubtless have been passed even if their revenue yield had been considerably less than it was.

It would be madness to impose taxes for revenue only and with blind disregard for their social and economic consequences. Every tax is, in some measure, regulatory, since it interposes an economic impediment to the activity taxed as compared with others that are not taxed. This was always true; it was trebly true during the war. In 1944 Federal income taxes, for instance, consumed about one-eighth of the income of individuals—nearly $20,000,000,000 out of $157,000,000,000. The extraction of such a sum from the pockets of the American people could not fail to affect their activities. Federal excise taxes and various state sales taxes took an additional toll. Corporate taxes deprived corporations of almost 60 percent of their profits. For many years estate taxes have hindered the transmission of great fortunes except through so-called charitable foundations.

From the standpoint of economic consequences, some taxes diminish spending power upon which the economy depends; other taxes reduce savings which in absorbable amounts are essential to the expansion of

the economy. Thus, if spending power is weak, taxes may contract markets. And, if savings are inadequate, taxes may impede the accumulation of wealth. Inordinate customs, such as those levied under the Smoot-Hawley Tariff Act, may stifle international trade. All of these consequences are profound, touching the economy at vital points. They should be prospectively valued before taxes are imposed, rather than after, when the damage has been done.

The social and economic effects of taxes assume their greatest significance and clarity when our personal interests are sufficiently concerned. Most people have not been interested in taxes as a means of curbing inflation, because until recently inflation seemed to them a distant evil which did not affect them individually. It appeared as remote as a famine in China, and men and women found it difficult to visualize its impact upon their immediate lives. But the officials of the corporation which secures percentage depletion have no difficulty in understanding the economic effect of lack of tax. And the volume of recent protest is rather convincing evidence that corporate officials generally think—undoubtedly correctly—that high taxes have economic repercussions. High taxes are said to induce waste and stifle incentive. Low taxes are said to encourage expansion. It is remarkable that some of the same corporate officials are able to preach with straight faces the doctrine that taxes should be for revenue only.

All talk of incentive taxation implicitly recognizes the economic influence of taxes. For the purpose of this discussion relief from taxation is the same as taxation. Taxes exert a powerful influence upon the economy; if they did not, it would be the most inexcusable hypocrisy to urge that high taxes hurt, and that tax concessions would help, the economy. One cannot argue in favor of high taxes or in favor of tax reduction on the ground that they are right or wrong *in vacuo*, or on the ground that some sacred principle is violated. Only the academicians get so exercised about principles. In taxation arguments are of a more earthy quality; those who contend that taxes are too high mean that their incomes or their profits after taxes are too low. All the rest of their talk is window dressing. The cardinal issue in tax discussions is not whether taxes will have an economic effect, but what the effect will be, and what its cost will be in other values.

There is more than a shade of difference between imposing taxes only after considering their social and economic effects, and imposing

taxes with the dominant purpose of achieving certain desired social and economic objectives. The first attitude is neutral. It conceives that the function of taxes is to raise revenue; but it refuses to try to raise revenue by methods which may be too costly in other directions. We need to look at taxes in a more positive way as an instrument of social and economic control wholly apart from the fisc, making revenue yield only part of the objective. In this role taxes may compensate for other movements in the economy. For example, by extending the holding period for computing capital gains, speculation might be discouraged. Excise taxes, bad in times of depression, may be counterinflationary in boom periods. Social security taxes are in the same category. These taxes may be used in inflationary periods as brakes on the economy. In deflationary periods other kinds of taxation may be advisable. The point is that taxes may be imposed, wholly apart from their revenue-producing qualities, to achieve desired effects on particular occasions. This is different from inquiring into effects when imposing taxes. It puts effects first, and taxes in the role of means to desired ends. It is the highest function of taxes to accomplish positive social or economic objectives beyond the revenue. They then become more than exactions to defray the cost of government; they reach the higher level of operation as instruments of human welfare.

On this higher level taxes may be used to express public policy on the distribution of wealth and income; progressive income and estate taxes perform this function. They may be used to subsidize or penalize particular industries and economic groups, as does the tariff. They may be used, as in the case of social security taxes, to isolate and assess directly the cost of particular benefits. They may be used to offset the ebbs and flows of business cycles, as in the case of steep income taxes which withdraw inflationary spending power. Taxes are now doing all of these things. But they are not doing them purposefully. They are not imposed deliberately to produce desired results; their effects are accidental because they are imposed principally to produce revenue. We may raise revenue by this approach, but at the same time we may find that we have accomplished other things that we neither intended nor desired. We are putting last things first. The process needs to be reversed. We must first determine our social and economic objectives, and then decide which taxes will lead us to our goals.

To say that taxes are not for revenue only is not to say that taxes

are not for revenue at all, although Professor A. P. Lerner and Mr. Ruml have gone that far. Professor Lerner says that taxes need never be levied so that the government will have money to spend; the government can always make the money that it needs, and "taxation should therefore be imposed only when it is desirable that the taxpayers shall have less money to spend, for example, when they would otherwise spend enough to bring about inflation." Mr. Ruml admits that state and local governments have to tax to provide the revenue they need to pay their bills, but argues that there is no necessity for a national government to tax in order to maintain its independence and solvency. Two important changes have occurred in the last twenty-five years which he believes have substantially altered the position of the Federal Government with respect to financing its current requirements. The first of these changes is a vast new experience in the management of central banks. The second is the elimination, for domestic purposes, of the convertibility of the currency into gold. Mr. Ruml points out that these new conditions free the Federal Government from the money market in meeting its financial requirements. He further believes that since all taxes have social and economic consequences, the government should look to these consequences in formulating tax policy. The "public purpose" which is served, he says, "should never be obscured in a tax program under the mask of raising revenue."

Another assumption implicit in much tax discussion is in complete conflict with the theory that taxes are for revenue only, though it is frequently made by the people who believe in this tired maxim. The assumption is that almost everything may be done by taxation. Those who look upon taxes as the only instrument we need to control the economy are of two classes: intense tax students who overmagnify the importance of their subject, and businessmen who think that almost everything can be accomplished by tax exemption or relief. The latter have not usually examined the intimate recesses of their faith in tax reduction. It really amounts to a belief in taxes as a medium of economic control, no matter how hotly they maintain that taxes should be for revenue only. No one can harbor these two convictions at the same time and keep his intellectual integrity. If the consequences of taxes are so great that tax relief can do wonders, it is logical to ask why so powerful an instrument as taxation should not be positively used to advance the well-being of every man, woman and child and every

business organization in the country. There is only one answer to the question that makes sense.

No single program can assure the mastery of our economic fate. We must look at taxes in their proper perspective. It is true that our choice of taxes will be a vital factor in maintaining production and employment in the postwar world. We know that bad taxes may be the millstone which can sink us in the whirlpool of depression. But we have no guarantee that good taxes will generate or maintain a boom. Good taxes may remove restrictions upon investment and consumption. But at the same time such powerful conflicting forces as price and wage policies, monopolistic control over productive resources and international trade barriers may nullify these effects. The formula for a dynamic economy is not discoverable by taxes alone.

Chapter 22

THE BUDGET AND TAX POLICY

THE future of taxation is more than a question of premises. Today we are confronted with a set of hard conditions. Here arises a question of attitude. We may wait supinely, with helpless fatalism, for an expected worst, knowing that the forces of the future will irresistibly trample down those who face them without will to act. We may refuse to see things in their true light, trying instead to recast what we do see in the desired image. Denying the importance of what we refuse to see is merely a gradation of this attitude. We may fight against controlling conditions with the bitterness that characterizes all fighting for ancestral feelings. Or finally, we may accept, and make the best of, what is inevitable and get speedily down to the business of intelligent control over what is only difficult.

Adopting this last attitude, we may as well steal a head start on the future by anticipating some of the hard conditions. The first of these is the Federal budget. We must have some conception of the magnitude of governmental expenditures if we are to formulate effective tax policy.

Before World War I the annual Federal budget amounted to less than $750,000,000. In the period between World War I and World War II it ranged from $3,000,000,000 to $9,000,000,000, averaging about $8,000,000,000 in each of the four years preceding World War II. During World War II it reached the fantastic total of $100,000,000,000.

At this date, when the scope for governmental decisions is so wide and the number of unknowns is so great, budget estimates made far in advance can at best be no more than educated guesses. We cannot know what the postwar international economic structure will be, or what political trends will be current, either here or abroad. We cannot at this time foresee precisely what defense and other necessities will

confront us. Even if national security were assured by an international organization to enforce peace, some economic philosophies would support greater governmental responsibilities—and expenses—than would be undertaken if more conventional philosophies were accepted. These are some of the imponderables which lie ahead.

There are, however, a number of commitments sufficiently fixed to permit a reasonably accurate future estimate. In addition, certain social and economic trends must be taken into account in any projection of the budget into the long-term future. About $5,000,000,000 is obligated to pay interest on the debt. Congress has pledged itself to finance veterans' services and benefits estimated at over $7,000,000,000 for the fiscal year 1948. Some of these costs, such as those for terminal leave, and unemployment and self-employment allowances, will be reduced in the near future, but over a long period these reductions will be offset by pension payments to veterans and their dependents. Government policy indicates that expenditures for international affairs and finance, estimated at $3,500,000,000 for the fiscal year 1948, may be cut before long. National defense, placed at $11,200,000,000 in the 1948 budget, has probably not yet fallen to its ultimate peacetime level. The development of military techniques for atomic warfare may point toward lower defense expenditures, but the process of change from one military technique to another is always costly. National defense expenditures must continue high unless some of the most serious international problems of today are solved more quickly than appears probable at the moment.

The rest of the Federal budget covers the expenditures of the administrative agencies and programs for social welfare, health and security, housing, education and research, aid to agriculture, public works, development of natural resources, and services to business and labor. These items aggregated about $9,000,000,000 in the 1948 budget. While much of the hue and cry for economy is vocally concentrated upon the ordinary costs of government, it does not take a very wise person to see that in many quarters the real attack is upon these programs. One of the questions of the immediate future will be the extent to which they should be financed by the government. It is improbable, over a long period, that the American people will be willing to permit major budget cuts at the expense of substantial diminution of programs which are designed to achieve a higher standard of living.

We must not overlook the fact that even though the budget, as recommended by the President, reflects the program of the Executive, the Legislative Reorganization Act of 1946 provides for a legislative budget. This provision charges Congress with the responsibility for looking at the budgetary picture from a comprehensive, rather than piece-by-piece, point of view. Together with the provision in the Employment Act of 1946 requiring the Joint Committee of Congress on the Economic Report to consider the over-all economic situation early in the year, the new legislative budget procedure should lead to greater Congressional recognition of the economic effects of government financing. The executive branch of the government cannot alone place government spending at a level which will take the best possible care in a particular period of the social and economic needs of the country. Nor can the executive branch assume responsibility for a Congressional budget. The ultimate decision on the amount of the budget is a Congressional prerogative, and blame for its size cannot reasonably be laid—as it sometimes is—at the door of the administrative agencies.

On their part, however, the administrative agencies initiate requests for appropriations on the basis of existing legislation, and preliminary hearings on these requests are held by the Bureau of the Budget. Later the administrative agencies defend the President's budget recommendations before the Appropriations Committees. The President's requests, couched in terms of the future, are usually stated in broad, rather than narrowly defined, terms. Rarely do the legislators have the time or the inclination for the detailed budget analysis which would be necessary to maintain exact control over government outlays. The budget-making process could be more effectively organized than it now is, but under present practices the executive branch must share responsibility with Congress for the amount of government spending, insofar as Congressional acceptance of the Executive budget leaves discretion as to precise means and scope of operation.

For some time postwar Federal budget estimates have been running to figures that would have sent chills down the spines of the most daring spenders of the thirties. Forecasts of expenditures have ranged from approximately $15,000,000,000 to $28,000,000,000 for the more distant postwar period. President Truman's $37,500,000,000 budget for the fiscal year 1948 included a number of aftermath-of-war expenditures. If we look at the subject realistically, only one conclusion is possible.

That conclusion is grim, but inescapable. Our Federal budgets of the fifties can scarcely be less than $30,000,000,000—at least seven times the budgets of the twenties and almost three times the highest budgets of the thirties. The pace and scale of Federal spending has reached a new era.

Not only the size of the Federal budget, but the whole question of budget policy is of great concern to our economy. Practically every individual and every business is affected when the Federal Government collects money from individuals and business, or pays out money to individuals and business. Consequently, the government's revenue, expenditure and debt programs have a decisive impact on individual and business incomes and expenditures. Budget policy may move in diverse directions. It may be steered toward achieving annual surpluses; it may merely seek an annual balance between income and outgo; it may be aimed toward a balance over a period of years, allowing for deficits in bad years; or it may be directed toward regular deficit financing. The policy adopted can either promote stability or contribute to instability.

I am convinced that an inflexible policy of seeking *annual* surpluses or even an *annual* balance of receipts and expenditures—regardless of the level of national income—would hamstring our economy and also fail signally to achieve its objectives. One thing that we must get out of our heads is the obsolete concept of the *annually* balanced budget, which has been derived in part from a false analogy to the individual's budget. The dogma of a balanced budget often fails to fit the economic situation. Although at times a balanced budget may be desirable, at other times it would be disastrous. In periods of actual or potential inflation a balanced budget is not enough. Under these circumstances we must have as big a surplus as we can possibly achieve in order to use the budget as a brake on inflation. At such times government expenditures must be cut down and taxes must be kept at a high level. Otherwise, to the extent that the government spends more than it receives, it aggravates the inflationary situation. But in periods when private investment is low, a deficit may be needed to stimulate investment and, perhaps, even to prevent a serious slump. The taxing and spending programs of the government can, and should be, adjusted to offset part of the upward and downward swings in total private expenditures. Maintaining stability in the economy by keying government expendi-

tures to shifting phases of the business cycle does not necessarily mean an increase in the public debt. Rather the contrary, for it may be the only feasible method of budget balancing over a reasonable period of time.

I can see no more reason for expecting a balanced budget to be a panacea for improving economic conditions than for considering a budget deficit—regardless of how it is incurred—to be a panacea for depression. Of itself the budget is not sacred. In depression periods, when unemployment is widespread, it cannot and should not be balanced. The choice then lies between deliberately unbalancing the budget by taking steps to bring back prosperity, or allowing it to become unbalanced because revenue has fallen off and emergency expenditures must be made. We do not consider a balanced budget a major factor in waging war; we should no more consider it a major factor in overcoming unwholesome conditions in our peacetime economy.

Once we accept the proposition that the purpose of our Federal tax system is not alone to raise enough money to balance all Federal expenditures, it follows that *how* the government raises taxes and spends money is far more important to the economy than the balance struck on the Treasury's books. If budget policy is to promote economic stability, our tax structure must be finely tempered to assist it. If our tax structure is to support the burden of increased peacetime expenditures, it is bound to be a much larger factor in the economic health of the nation than ever before. It must be able to produce more than it did before the war without overburdening the active elements in the nation. If our tax structure is to help in stabilizing employment, it must be highly flexible and geared so that changes may rapidly take effect. In the light of these conditions, we should consider how our tax system can be adapted to the tasks it is called upon to perform.

Since we cannot know in long advance the trend of economic events, our tax structure should be designed to meet all possible contingencies. If we assume that economic conditions in the postwar period will in the long run be deflationary, because of a tendency to oversaving, we shall want taxes which have the least depressing effect on private spending. A tax structure which depresses private spending least will help to maintain maximum employment and necessitate a minimum increase in the national debt. The prudent and conservative course is to gear our basic revenue structure to a deflationary situation, but to make it suf-

ficiently flexible to meet changing economic conditions as they arise. If we pursue this course, in an acute inflationary situation the problem will not be to change the structure, but merely the rates of tax. In depression phases of the business cycle tax rates may again be reduced, especially in the lower brackets, to stimulate private spending. At other times they may be increased to curtail spending. The effect of rate changes may be felt promptly now that we have collection-at-the-source and, in addition to fulfilling their traditional function of raising revenue, taxes may operate to forestall an incipient inflationary boom or to check a down turn in business activity.

Chapter 23

THE NATIONAL INCOME

THE second hard condition upon which future tax policy depends is our national income. In appraising this factor we must be aware of what it consists and its probable magnitude. A healthy post-war economy calls for the production and consumption of a supply of goods and services unprecedented in peacetime. The production of goods and services is accompanied by the creation of an equivalent amount of money income. For example, an automobile is built and sold to Mr. Smith. The automobile manufacturer pays wages to his employees and dividends to his stockholders. He pays other producers for the materials they supply. He lays aside part of his receipts to cover depreciation and to pay his taxes, and he has some money left that represents spendable profits. This same process takes place in the whole field of production from raw materials to finished products. As a result, individuals and business enterprises receive money income which in the aggregate equals the value of total production in the national economy. In addition, individuals receive money from governmental payments which do not rise out of current production, such as relief, pensions and social security benefits. As a total, then, the country's income is equal to the combined expenditures of individuals, corporations and government; total spending and total income are exactly the same figures.

There are a number of concepts of income in current use, each of which serves a particular purpose. The most inclusive of these is "gross national product," the sum total of finished goods and services produced in the country. This term also represents the income generated in the process of turning out that total.

"National income" is the income of individuals and businesses earned in production. It includes wages and salaries; corporate profits after

taxes; interest, rents and royalties; and the net income of families, professional people and business proprietors. In a sense, it is a kind of net national product. It may be arrived at by deducting from gross national product the items of business taxes and allowances for depreciation, depletion and other business reserves.

The third income concept in common use is "income payments to individuals." It represents the sum of all income flowing to individuals. Unlike national income, it includes governmental payments in the form of pensions, relief, social insurance benefits and benefits to veterans. It excludes items of income not actually received by individuals, namely, profits earned by corporations but not distributed as dividends, and social insurance taxes on both employers and employees.

Finally, the concept of "disposable income of individuals" is sometimes used to describe the income that individuals have available for spending or saving. It is arrived at by deducting personal taxes from "income payments to individuals."

In 1946 gross national product amounted to $194,000,000,000, national income reached $164,000,000,000, income payments to individuals approximated $163,700,000,000 and disposable income of individuals was estimated at $144,500,000,000.

For some time published prophecies as to our postwar national income have covered such a wide range as to suggest Euclid on a binge. Confusion arises because the computations are made for different years and in terms of different assumptions as to price levels. For example, one prominent prophecy is that of Mr. S. Morris Livingston in *Markets After the War*, published by the Department of Commerce. Mr. Livingston's estimate is $134,000,000,000 at 1942 prices. In "Jobs After the War," published in *The Federal Reserve Bulletin*, Dr. E. A. Goldenweiser and Dr. Everett E. Hagen prophesied $142,000,000,000 at 1943 prices. Considering the difference in 1942 and 1943 price levels, these estimates are about the same. In terms of prices in the last quarter of 1946 they indicate a national income in the neighborhood of $175,000,000,000.

The Federal budget for the fiscal year 1948 was predicated on a national income of $166,000,000,000, the assumption being that business activity would average slightly higher than in the calendar year 1946. But national income in the future depends upon the price level as well as the amount of business activity. One danger we face is the possibility

that prices may rise to such an extent that the consuming public will be priced out of the market. In such circumstances national income would fall substantially.

Until recently, a general feeling of optimism existed about national income in the near future because of the high volume of liquid assets available for spending and the long-deferred demand for consumer's goods. During the war individuals earned much more than they were able to spend; in 1944, for example, they saved more than 28 percent of their income after taxes. On June 30, 1946, they had a total of $152,000,000,000 of bank deposits, currency and government securities on hand. This was an increase of over $100,000,000,000 from the end of 1939. Much of this heavy saving reflected patriotic bond purchases, shortages of civilian goods and effective price ceilings. By the end of 1946 patriotic urges had weakened, production had increased significantly, and general price control had been eliminated, with an attendant sharp drop in the purchasing power of wages. The result was a substantial decrease in the rate of saving. In the last quarter of 1946 individuals were saving less than 10 percent of their income after taxes. Installment and credit buying had rapidly increased. Most families had found it necessary to supplement current income with past savings, a practice they could not continue for any considerable period. Surveys made in 1946 indicated that about 24 percent of American families held no War Bonds or bank accounts in 1945, and 29 percent held less than $500 of savings in these forms.

A high national income cannot be sustained indefinitely by deferred needs supported by a backlog of savings. Consumer demand depends upon current disposable income which, in most instances, depends upon employment. At the first sign of unemployment, even those who have jobs may feel insecure and spend less. Fear of prolonged unemployment makes people hesitant to part with their savings except for absolute necessities. This is bound to reduce demand, for demand is directly related to the worker's idea of the security of his pay envelope. Our hope for the future lies in the development of integrated governmental and business policies which will enable us to maintain a national income consistent with maximum production and maximum employment.

Chapter 24

CONTROLLING OUR ECONOMIC FUTURE

A LAW was enacted in February 1946 which indicates that a full employment national income is not an impossible ideal. While the statute does not use the words, "full employment," its objectives are substantially full employment. The important step forward is that the Employment Act of 1946 proceeds on the general assumption that the Federal Government has the ultimate responsibility for creating and maintaining a general framework for economic activity conducive to the achievement of "maximum" employment. The law assumes that the way to deal with depression is not to wait until it has progressed beyond control, but to be forearmed with measures that will prevent it from becoming disastrous. The act does not present a specific program, but it does set a policy and establish machinery for discharging the Federal Government's responsibility for maximum use of the nation's capacity to produce and consume—and therefore to employ. And it recognizes that the creation and maintenance of employment opportunities in a democracy must be a joint undertaking of all citizens.

In its declaration of policy the act sets forth the responsibility of the Federal Government

> to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and co-operation of industry, agriculture, labor, and state and local governments, to co-ordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production and purchasing power.

Such being the responsibility of the Federal Government, how does the government go about meeting its responsibility? The act does not say precisely what steps should be taken, but it defines a method of determining the steps to be taken. It specifically directs the President to submit an annual report on the state of the nation in definite terms of jobs and all that goes to make jobs. The President may also make interim reports indicating changes in the employment situation and the need for government action in the public interest. The annual report is to state:

1. The existing levels of employment, production and purchasing power, and the levels needed to carry out the statutory declaration of policy;

2. Current and foreseeable trends in the levels of employment, production and purchasing power;

3. A review of the Federal Government's economic program, together with a review of economic conditions affecting employment in the previous year and their effect upon employment, production and purchasing power; and

4. A program for carrying out the government's declared policy, together with such recommendations for legislation as the President considers necessary or desirable.

A council of three economic advisers is to assist the President in this undertaking, and serve as a continuing body to study employment and production problems. The advisers are to be selected by the President, subject to Senate confirmation. They are to be chosen on the basis of exceptional qualifications to analyze and interpret economic developments, to appraise the programs and activities of the government in the light of its declared policy and to formulate and recommend national economic policy to promote employment, production and purchasing power under free competitive enterprise.

Finally, the act establishes a Joint Committee on the Economic Report composed of fourteen members of Congress to make a continuing study of matters relating to the Economic Report, to study means of co-ordinating programs to further the policy of the act, and, as a guide to the various Congressional committees dealing with legislation relating to the Economic Report, to transmit its recommendations once a year to Congress.

Such is the Employment Act of 1946. Three points are especially

worth noting. One is that it calls upon the Federal Government to "co-ordinate and utilize all its plans, functions and resources" to achieve maximum employment. Thus, it envisages an obligation on the part of the Federal Government in co-ordinating its policies, performing its functions and carrying out its plans, which goes beyond the mere expenditure of money.

The second point is the legislative recognition of the necessity of new methods of procedure, if Congress is to do its part in maintaining an economy of full production and full employment. As long as different Congressional committees develop related types of legislation without recognizing their bearing upon one another, effective national policy will be difficult to achieve. By establishing the Joint Committee of Congress on the Economic Report the act makes an important improvement in Congressional procedure for undertaking the most important domestic job of the future.

The third point is that original responsibility for developing the maximum employment program is put with the President. The Council of Economic Advisers is entirely subordinate to him. It has no independent nor autonomous authority. Its members can be removed by the Chief Executive at any time.

It is hardly surprising that the Employment Act has been subjected to attack. One charge accuses the act of being verbose and meaningless and prophesies that it will not work. While it does not contain all of the language and provisions that might be desired, the act is, nevertheless, a measure that can be made to work if there is a genuine and sincere desire to achieve its objectives. Of course, the wisdom of Congressional decisions will largely depend upon how well the people understand the economic problems facing the country, what kind of position they take on those problems and how effectively they make their voices heard. Moreover, little will be accomplished without courageous and forceful implementation of the statute by future Executive and Congressional action. But if popular interest in our economic problems is so widespread as to compel a satisfactory Executive and Congressional response, the act may well become a great charter for building a better future.

Very much will depend upon the caliber of the men selected from time to time by the President to make up the Council of Economic Advisers and the men selected by the President of the Senate and the

Speaker of the House to make up the Joint Congressional Committee. For the first requisite in making the act an effective mechanism for achieving broad economic ends will be qualified personnel. Unless the persons chosen for the vital council and committee posts are, in fact, exceptionally qualified and wholeheartedly devoted to the principle of full employment, the measure can easily become meaningless and unworkable, and a mere front for doing virtually nothing to put our economic resources to their maximum use.

From the beginning attempts have been made to undermine the basic principle of the Employment Act on the ground that the government, in assuming responsibility for maintaining full employment, was interfering with private enterprise. But history offers no evidence that private enterprise can or should assume full responsibility for the smooth functioning of the economy, or that it can deal adequately with the unemployment ailment which plagued us in prewar years. Factors are involved over which private enterprise does not, and cannot, have full control. Moreover, government action represents no break with the past. In 1791 Alexander Hamilton, the first Secretary of the Treasury, called for some "degree of support from the government," some "incitement and patronage" to stimulate capital whenever it threatened to become sluggish. It is an American tradition that the government, representing all of the people, should take the economic steps necessary to make us a prosperous nation. This tradition dates back to the first commerce acts following the Revolution, the homestead legislation of the Civil War period, the banking and antitrust statutes enacted just before the turn of the century, and the agricultural, labor and social security legislation of the thirties.

Still another criticism of the Employment Act derives from an indiscriminate identification of all planning with dictatorship. Some critics of this stripe may be easing a sense of guilt about wanting to do nothing to improve our economic system by saying that by doing nothing we escape the perils of regimentation and totalitarianism. They damn all planning as a "road to serfdom," or the "predecessor of Fascism," or the "deadly enemy of free enterprise." But such oratorical epithets misstate the issue. More often than not the greatest enemies of free enterprise are those who talk most heatedly about its virtues. If we blindly refuse to meet the unemployment problem dynamically by

planning, rather than statically by drifting, we may well find ourselves slipping down smooth grooves to Nazism and Fascism.

Of course, there is danger. But in this territory the greater danger lies in an inert policy. Another disastrous and prolonged depression would certainly lead to more extensive government controls than we have ever known in peacetime. Wide-scale joblessness, rotting crops, protracted labor quarrels, bitter class conflicts and unrestrained pressure politics, play directly into the hands of the enemies of free enterprise. We might not use the term "Fascism" for the mass movement that emerged from such chaos. It would probably be heralded by some contagious home-grown slogan. And whatever its form and content, the movement would probably be called the American way of life. But labels count for little, and a movement of this kind, by whatever name it was called, could be the death sentence of free enterprise.

The question is not whether we should accept or reject government participation in the nation's economic life, but whether we should choose and implement those policies which are best designed to encourage employment under a free enterprise system. Through the kind of governmental action that we term fiscal policy we can deliberately undertake to keep the economy on an even keel. To bring about full employment of man power and full employment of productive power in peacetime will be no easy task. We may not wholly succeed, but we dare not wholly fail. We shall be wise to attempt a great deal in order that we may gain at least a little.

Some defeatists claim that it is beyond human power for economic advisers to make accurate forecasts a year in advance as to how individuals and businesses will spend their money, and how many people will be employed. But the fact that the appraisal is beyond the realm of positive knowledge is no reason for refusing to undertake any appraisal. It will be an experiment, as all life is an experiment. If it is flexible, if it plays the law of probabilities, it will be far better than no forecast at all. Almost every day we have to stake our future upon some prophecy based upon incomplete knowledge. It is the very incompleteness of our knowledge which makes it necessary to plan for every possible contingency. If the Economic Report is prepared by the most competent men the nation affords, it should be of incalculable value in giving a reasonably accurate annual appraisal of how our economy is

operating and the direction in which it is moving, and thus obviate the risk of flying blind into the economic crises of the future.

Other critics have been startled by the novelty of the concept of controlling our economic future. Experiment on a large scale frightens them into a retreat from the obvious direction of events. American history is a continuous story of victory over this kind of timidity. John Quincy Adams pointed out that the Constitution had been "extorted from the grinding necessity of a reluctant nation." This is the way most advances come in human society. The short answer to these critics is that democracy must learn to cope with economic, as well as political, problems if it expects to survive. For economic problems will not solve themselves; we shall solve them because we must. But their solution will call for all the ingenuity and courage a democratic nation can marshal.

To complicate matters further, there is also the problem of special interest. As specific measures to implement the Employment Act are proposed, we can be very sure that various groups will become vocal in their own behalf. All groups are in favor of solving the problem of unemployment—if, in the immediate sense, the solution does not mean paying the price in reduced profits, or higher taxes, or lower interest rates, or abandoning particular practices or sacrificing any of the powers or privileges they now enjoy. These groups rarely object if their own class is benefited. But when a proposal promises to work to the supposed disadvantage of a particular group, an understandable human frailty asserts itself. Then the more remote general interest fades into a shadowy background and the dirge of complaint rises to a crescendo. It is perhaps the most chilling commentary on our times that immediate self-interest, dressed up in sonorous sophistry, too often cancels out more remote general values, even though the self-interest may be misguided when all factors are taken into account. What we need and what we must have is a constructive national, rather than group, attitude, a more catholic concept of the goals we seek, and a greater sense of urgency about reaching and holding fast to those goals. For in the long run, only by subordinating immediately selfish motives to the common good can we attain lasting prosperity.

The great necessity that America achieve full employment has been put forcibly by Eric Johnston, former President of the United States Chamber of Commerce:

> Two powerful nations, Russia and the United States, will enter the postwar world representing opposite poles of economic and social thought. The Russian system will be propagandized. Ours will be, too—I hope, by example. . . . The test will be our ability to solve the problem of unemployment. . . . I believe we can solve it on a democratic basis.

Our economy has never provided stable full employment under modern conditions of high labor productivity and mass production. We have seesawed between booms and busts for decades. In the early days the booms and busts were relatively limited. But the great depression which followed World War I was eradicated only by World War II. This generation has seen that war and depression and unemployment are curiously related. Depression and unemployment come only when we are at peace; in wartime they disappear. Yet no sane person would seriously choose to abolish depression and unemployment by resorting to war. The Employment Act of 1946 attempts by advance planning to enable us to enjoy the sustained benefit of our productive capacity without the lash of war.

Depressions are costly affairs. It has been estimated that the depression of 1929 to 1941 cost the businessmen of America over $300,000,000,000 in lost sales—more than our entire war debt—that it cost corporations $69,000,000,000 of potential profits, that it cost workers in private industry $175,000,000,000 in potential wages and salaries, that it cost farm operators $24,000,000,000, and non-farm proprietors and professional men $37,000,000,000 of potential net income. These figures call loudly for preventive measures. We cannot afford losses of this magnitude a second time, and we can much less afford the human casualties the statistics cannot portray.

Nor can we overlook the fact that full employment is the surest road to lighter tax burdens and a manageable debt. For full employment means a high national income; the higher our national income, the lighter our tax burdens become and the easier it is to keep the debt under control. If we hope to achieve considerable tax reduction and yet balance the budget, we dare not conclude that substantially full employment is an impossible ideal. In this instance Ralph Barton Perry's statement rings true:

> Ideals are not idle dreams or rosy pictures . . . they are goals to be achieved by human flesh and blood and embodied in a firm

structure of physical and social organization. In other words, an ideal is something to realize.

As we move toward better solutions of our economic problems we must be ever mindful that depression in the United States will mean unemployment and economic dislocation throughout the world. Unemployment makes men afraid, and from their fear springs hate. If we fail this time to build a solid basis for world-wide prosperity, programs for collective security will be powerless to prevent the rise of new tensions, new hates and new dictatorships as tawdry as they are vicious. Full employment in America is a basic component of world political and economic security. It is probably the best single move we can make toward permanent peace. As former Secretary of State Byrnes has said: "The example we set will certainly affect, and may even determine, the direction of the world's political and economic development."

Chapter 25

MANAGING THE DEBT

BACK in 1941 a news-hungry reporter asked William S. Knudsen, then head of the Office of Production Management: "What are your difficulties now?" Mr. Knudsen, beaten down by eighteen months of "defense" mobilization, looked up and said: "Difficulties? We have no difficulties. Don't you understand your country is at war?"

War was the great mobilizer of human energies and of the national economy. World War II has cost the United States about $335,000,000,000, or approximately ten times as much as the last war. These expenditures did not cease abruptly with the termination of hostilities. High government expenditures will hardly cease entirely within the lifetime of anyone living today, and perhaps not for several generations.

During the period following World War I the country was still committed to the traditional American policy of paying off the national debt in peacetime. This policy prevailed up to the thirties. In 1919 the debt stood at $25,000,000,000. It was reduced under Secretary Mellon to about $16,000,000,000 in 1930, but the depression ushered in a decade of unbalanced budgets and deficit spending during which the debt increased from $16,000,000,000 to more than $40,000,000,000. On December 31, 1941, just after we entered World War II, it had reached $58,000,000,000. In 1945 it had soared to nearly $260,000,000,000, which was almost $100,000,000,000 more than the national income of that year. In February 1946 it reached a peak of $279,000,000,000, a sum which scarcely anyone would have dared contemplate a few years ago. A debt in excess of $200,000,000,000 is in all probability a permanent fixture in the lives of the present generation. This is another hard condition to be faced in the years ahead.

Two hundred billion dollars is a tidy sum even in these astronomical

days. But there is more to a national debt than its size. A debt figure means nothing in a vacuum. It has significance only in relation to other items, particularly the national income, the annual carrying charge, the distribution of the debt, the distribution of income and the tax system. These relationships determine whether we have a manageable debt.

British experience shows that a nation can carry—not with entire comfort, but without too much difficulty—a debt of twice its national income. In 1817 at the end of the Napoleonic wars the British debt was £850,000,000. The annual national income was £400,000,000, making the percentage relationship of debt to income 212. In 1936 the debt of the United Kingdom was well over twice its national income.

If our national income is $170,000,000,000, the parallel would be in the neighborhood of $350,000,000,000. If our income rises, as it has in the past, it is not only conceivable, but indeed probable, that we can handle a constantly increasing debt. History affords a definite basis for optimism on this point. In 1914 our national income was only $34,000,000,000. Several factors—an increased labor supply emerging from an increasing population, increased productivity per hour because of technological advances and better management, and increases in pay rates and prices—brought national income to nearly five times that amount in 1944. In terms of 1914 prices this is an increase of about 230 percent.

Geoffrey Crowther, the British economist, has estimated that this country should have a national income of $330,000,000,000 in the year 2000. This is not by any means an unreasonable estimate and assumes a less rapid rate of progress than we have made in the past when our national income has doubled about every twenty years. With a rising national income we can stand a high level of public debt; a rising national income is symptomatic of a high level of employment which, in turn, means that we can meet our financial obligations without undue difficulty. With a national income of $330,000,000,000 we could manage a substantially larger debt than we now have. We must not forget that against the rise of public debt are to be put the income-earning assets that are provided through the expansion of debt, the rise of income and the corresponding rise of tax capacity.

The American national debt carries an average interest charge of less than 2 percent, and about one-third of that is returned to the government in income taxes on interest earnings received by holders of

government bonds. In terms of carrying charges the debt is about 40 percent of what it would be if the average charge were 5 percent. And it is even possible that some of our debt may be converted, now that the war is over, to a lower interest rate. Such things have been done by the most conservative bankers in history.

The average interest charge on the national debt should also be compared with the national income. The interest charge on our national debt would approximate about 3 percent of our national income, if our national income were $170,000,000,000. This ratio is below that of England for long periods of her history. In 1818, after the Napoleonic wars, and again after World War I England paid about 7 percent of her national income for debt interest. Today she is paying less than 6 percent of her income for interest on the debt.

So far we have been looking at the dark side of the debt picture. There is a much brighter investment side; sometimes even the people who fear the debt the most talk about the good it will do by providing money for a spending spree which will help business. Such confusion of thought requires that we examine the debt question on a less superficial and conventional basis.

The American national debt is internal. On one side there is debt, on the other side investment. The American people are on both sides of the balance sheet. The annual interest on our debt is paid *to* our people as well as *by* our people, and therefore by no means constitutes a net loss to the economy. Contrary to popular impression, it would be a revolutionary, perhaps catastrophic, procedure to pay off our debt suddenly. If by some miracle our debt were paid off tomorrow, our entire financial structure would be disrupted, for the whole pattern of our economy has been woven about the availability for investment of the securities representing the national debt. Our debt gives insurance companies, banks, savings and loan associations and other investors a profitable outlet for funds which might otherwise lie idle. This is not to say that we would be worse off with a smaller debt, particularly after the process of adjustment to a reduced amount had been completed. Nor is it to say that we should not be concerned about our debt. We should be concerned—but for the right reasons. One reason is that the debt means a large inelastic item in the Federal budget. But a more important reason is that the debt has a considerable effect on the distribution of income.

In England after the Napoleonic wars the bonds representing public debt were largely held by the rich. Taxes were mostly mass consumption levies on the poor. There was much truth in the bitter allegation of that day that the debt forced the payment of tribute by the productive masses to the idle rentier class. It was said to make the rich richer and the poor poorer. The term "taxeater," which first came into use after the Napoleonic wars, connoted not the bureaucracy, as it does now, but the wealthy bondholders.

In the United States today such fragmentary evidence as we have indicates that a preponderant share of government bond holdings is held by the upper income groups. Recent surveys on the distribution of liquid asset holdings suggest that very little of the debt has been pumped into the hands of the lower income groups. In terms of distribution by size of income, the ownership of our national debt leaves much to be desired.

On the other hand, if we disregard the distribution of the debt among income classes, we find that our debt is widely distributed on the investment side; more than half of it represents the savings of individuals, or investments of funds received from individual savings by insurance companies, mutual savings banks, savings and loan associations, trust funds and other agencies. From the individual standpoint government bonds provide security for times of distress. The wider the distribution, the more have security. From the collective standpoint a wide distribution helps safeguard us against future depression by providing a reservoir of buying power. A considerable portion of the bonds representing our debt is owned by the commercial banks. Of course, they receive revenue from the Treasury in the form of interest, but in return they render a costly service in handling the bookkeeping involved in our checking operations. Without that revenue they would be obliged to charge for this service. In this sense the benefit of the debt in the hands of the commercial banks is widely distributed, at least among checking-account holders.

Our taxes determine the fashion in which our financial responsibilities for paying interest on the debt are distributed. While the government collects the money for servicing the debt from the people, it does not collect it in equal amounts. For example, a family of four with an annual income of $2,500 pays about $25 a year in income and excise taxes for its share of the national debt service, whereas a family of four

with a $10,000 income pays about $400. Our existing taxes are relatively progressive. However, they are not as progressive as they should be, and our debt is not as widely distributed as it should be in view of the apparent concentration of government bonds in the hands of the upper income groups. If our taxes were more progressive, the interest charges on the debt would fall less heavily on the lower income groups and more heavily on the upper income groups.

Many people contend that a large debt, or an increase of debt and the expansion of money, means inflation. This is not necessarily so. During the thirties the growing debt did not exert inflationary effects. Prices depend upon the relative amounts of goods and money. If the debt is increased because private money is not being spent and there is a hiatus between saving and investment, the new money merely takes the place of the private money that is lying idle. This is not inflationary. The government is justified in creating new money only because the new money makes it possible to produce more goods. So long as the supply of new money the government creates calls forth a rising supply of goods, rather than a mere increase in prices, it brings us nearer the goal of full employment. Of course, when the newly created purchasing power starts to inflate prices and wages instead of putting unemployed resources to work, the danger signals on deficit financing should be hoisted.

Inflation for any extended period in this country is possible only during periods of full employment. Short of full employment it is always possible for idle plant and man power to produce more goods. The eventual solution of the problem of inflation lies therefore in increased production. It is true that increasing the debt is dangerous when we have peak employment. But what we have to fear ultimately is unemployment. It may be necessary to increase the debt at times when we are unable to develop sufficient demand for all our productive capacity and unemployment threatens. Conversely, we should reduce the debt when the economy is running full steam ahead with demand that exceeds our productive capacity.

It is simple arithmetic that continuous borrowing will result in an ever-growing public debt. It is also true that with a nonfalling interest rate and the continuance of present financing practices interest charges will grow; and, if all funds for paying interest charges are to be raised by taxation, the absolute amount of taxes to be collected for that pur-

pose will increase at the same rate. But these absolutes do not mean a great deal. Moreover, the government always has an ace up its sleeve; the question has been raised in some quarters whether the government should continue to pay interest to the commercial banks (as distinguished from individuals, insurance companies and other investors) as it does now. Interest is said to be justified to the extent that it enables the banks to pay interest to time depositors and to provide free services benefiting the public, but the argument is that this concealed subsidy should end and that a method of distributing government bonds through the Federal Reserve System might be devised under which that system would derive the advantage of any interest charges payable.

Continuous government borrowing, not accompanied by a rising national income, will result in an ever-rising debt burden in addition to other possible economic dislocations. To have a rising income both public and private investment expenditures must increase. If our national income rises rapidly enough, we need not worry about the absolute increase in the debt. With a rising national income the debt could rise, yet its ratio to national income could fall. This relationship is an important test of a manageable debt.

The people who talk about the "burden" of the debt are referring to the tax rate which must be imposed to finance the service charges. That burden roughly equals the ratio of interest charges to national income. The problem of the debt burden is, therefore, essentially a problem of achieving a high level of employment and with it a rising level of national income. The faster income grows, the lighter a given debt burden grows. The tax rate and the ratio of debt to income will be lower the faster income rises, even though a more rapidly rising income results in a larger absolute magnitude of the debt.

A $170,000,000,000 national income can easily yield us sufficient Federal taxes to carry our present debt burden and other expenses. Moreover, as national income rises, tax yields rise in proportion. But if we should allow the national income to fall to $100,000,000,000, we should need more than $30,000,000,000 of taxes to take care of our debt and other government expenses which would include the care of about 20,000,000 people who would then be out of jobs.

Some economists and politicians are burning with a desire to reduce the debt burden. The only method they recognize to achieve their goal is reduction of the absolute size of the debt; they take it for granted

that the government must stop borrowing and pay back some of the outstanding debt. They should take care, however, that the tax and other policies they advocate do not exert such a depressing effect on the national income as to result in an actually heavier debt burden. Trying to repay the debt when deflation threatens and considerable unemployment exists is penny-wise and pound-foolish. Income will decline in greater proportion than the debt and the debt burden will actually grow. If our national income fell to $80,000,000,000—which it was in 1929—the debt burden, in the real terms of relationship between carrying charges and national income, might be more than we could comfortably bear. As President Truman stated in his Budget Message of January 1947, "The best method of keeping down the burden of the debt is to maintain prosperity."

It is at least clear that the national debt is no occasion for black defeatism. What we need is a new outlook. We need to exorcise the old-fashioned taboo against the national debt. The debt does not betoken economic ruin; it can be maintained indefinitely. This country has not been wholly out of debt since 1837. We need to recognize clearly that public debt is unlike private debt. A hundred years ago Lord Macaulay, recounting the cries of anguish and despair over the growth of the British debt, wrote:

> The prophets of evil were under a double delusion. They erroneously imagined that there was an exact analogy between the case of an individual who was in debt to another individual and the case of a society which is in debt to a part of itself. They made no allowance for the effect produced by the incessant progress of every experimental science and by the incessant efforts of every man to get on in life. They saw that the debt grew; and they forgot that other things grow as well as the debt.

We need to see that the debt can be a useful instrument, and is not an unmitigated evil. When the debt increases, that is, when the government borrows and spends, the national income generally increases. By coaxing idle dollars out of their hiding places or by creating new dollars of bank credit and making use of them, government borrowing swells the income stream. When the debt is reduced, that is, when taxes yield larger sums than the government spends, the national income generally falls. By removing active dollars from the market or by de-

flating bank credit, debt repayment cuts down the flow of purchasing power. We need to see that increasing the debt can put idle resources to work; because of the increased liquidity and financial security it gives to investors, it may stimulate both investment and consumption. We need to see that decreasing the debt can check inflation. Finally, we need to see that an increase in debt is the lesser of two evils when the alternative is widespread unemployment.

This nation is not going bankrupt. If the government continually spends more than its income, it will not go broke; it can always recover an equivalent amount in taxes. Taxation to pay the interest on the national debt affects individuals for better or worse, but it does not make the nation poorer. During the war period the financial condition of state and local governments improved greatly as a result of huge Federal deficits, and business derived enormous benefits from Federal expenditures. The war increased, rather than decreased, our real wealth. We have increased capacity to produce, new and more varied skills, expanded and diversified institutions and plants and equipment, and increased tax capacity. In 1932 we had a national income of $40,000,000,000; the taxes to pay the interest on the debt amounted to $600,000,000, which left $39,400,000,000. In 1946 we had a national income of $164,000,000,000; the taxes to pay the interest on the debt amounted to $5,000,000,000, which left $159,000,000,000. Even allowing for the large increase in total taxes, this is hardly the pattern of bankruptcy.

Chapter 26

THE CONSEQUENCES OF IDLE SAVINGS

If we are to maintain a high national income in the years ahead, still another problem must be faced. That problem has to do with uninvested savings. The problem need not concern us too much at the moment while inflationary pressures are heavy because business is eager to make capital expenditures and consumers are eager to buy goods that were scarce during the war. But after these demands are satisfied, there is the danger of deflation, unemployment and a lower national income, if we revert to our prewar spending and saving pattern.

Henry Thoreau to the contrary, one of the good portents for the future is that Americans are a spending people. We like to buy automobiles, refrigerators, washing machines, typewriters, radios, good food, good clothing and good houses. The author of *Walden* would say that we tend to be so preoccupied with aids to living that we clutter up our lives with them and make ourselves their slaves. Thoreau made comforting reading in days of wartime shortages. By restraining ourselves from buying and by saving all that we can when goods are scarce, we help to avert inflation. But at other times the same kind of conduct helps to bring unemployment and waste of resources.

The less well-known truth is that Americans are also a saving people. Along with our propensity for acquiring things goes a deeply ingrained desire to lay something by for a rainy day. The saving habit is deep in our bloodstream. As children we were taught to put our pennies in the bank. As workers we are paying social security taxes to give us some small measure of security in our old age. As citizens in wartime we salted money away in War Bonds at the rate of almost $12,000,000,000 a year. Even in 1932, with a national income of only $40,000,000,000, individual savings amounted to more than $2,500,000,000, or 6½ percent

of the meager national income of that year. In 1944, because of shortages in civilian goods and services and a patriotic sense of restraint, individual savings mounted to the phenomenal rate of about 28 percent of national income, or about $39,000,000,000.

From an individual standpoint Benjamin Franklin was right: saving, frugality and personal economy are virtues—at least when they are not carried to extremes. We hope that they will accomplish two results. We expect them to provide education for our children, and security against our own unemployment, sickness and old age. Our existing social security program is too inadequate to affect this motive. In addition, savings spell personal wealth and power, unless a depression wipes out all that we have managed to set aside, as has happened so often in the past.

On the other hand, from the national viewpoint large savings bring problems and are one of the factors which tend to throw our economy out of balance. It is therefore incumbent upon us to order our customs and practices so that a laudable individual trait will not be permitted to become a collective evil.

Our economy depends upon spending or, on the other side, selling. It is a fundamental proposition that production and buying power generate each other. The more we spend, the more we have; for the more we spend, the more we can produce; and the more we produce, the more income we shall have for spending; and, if that income is not diverted from the spending stream, the more goods and services will be produced for society as a whole. But successful businessmen are canny. They will not produce goods that cannot be sold; overproduction is too costly. It follows that underconsumption, or underspending, will cause producers to cut their output. Production cuts mean idle plants which, in turn, mean idle workmen, less national income, still less production, more idle plants and more idle workmen. This is the vicious downward spiral of deflation.

Savings are no problem if they flow constantly into new investments. They are no problem if savers invest them directly in their own enterprises, or put them into banks and other institutions which lend out funds to start new, or expand old, businesses. In fact, we can have active business conditions only by directing that portion of our income which is not spent on consumers' goods and services into capital expenditures by business and government, so that it is poured back into

the income stream. If savings are not put to this constructive use, if they are not directed into creative investment, the flow of income will become clogged, and employment, production and national income will bog down. In the words of James W. Angell,

> A society which elects to hoard part of its receipts of money income is failing to exploit its natural resources to the full just as genuinely as a society which elects to spend part of each working day in bed.

Savings are no problem insofar as they are absorbed in new plant and equipment and new homes, and are utilized in other ways which put the savings back to work. These other uses include increased business inventories. But increased business inventories cannot be counted upon indefinitely as a use for savings. Business inventories can be expanded for only a limited time before they get out of line with consumption. And they cannot be expanded out of proportion to the prospect of selling merchandise profitably. As long as we are filling our postwar pipelines of raw materials, goods in process and finished goods, inventories will rise rapidly. Production will generate income at a faster pace than it will generate finished goods upon which to spend that income. But once the economy has caught up with itself, the flow of goods for sale will overtake the flow of income from production. At that point we shall need to take measures to sustain consumer demand, or face the prospect of a recession.

Another use for savings is through net export sales financed by foreign loans. We shall undoubtedly sell large quantities of goods abroad while foreign countries are in the process of reconstruction and need our goods and skills. For as long as other nations take goods from our home market and pay us in gold or credit or dollars, export sales will help to provide a use for savings amassed because of lack of spending at home. But investment in foreign balances creates many problems. To enable other nations to continue to buy from us, we must make ever-increasing foreign loans. These loans are not likely to be extended unless there are good prospects for at least the payment of interest. There are practical limitations upon payment in gold from other nations, not the least of which is that we already have about two-thirds of the world's gold supply. The ability of other nations to pay us in dollars depends upon the extent to which we make dollars available to

them through imports of goods and services, including personal remittances and tourist expenditures, and through new investments abroad.

As long as new American investment abroad exceeds payments on outstanding foreign investment, the question of net repayment on our total foreign investment will not arise. But when net repayment eventually begins, it will involve an excess of imports of goods and services over exports. Repayment in the form of imports has been traditionally opposed in this country on the ground that it causes competition for domestic producers and contributes to unemployment. We are therefore faced with the alternatives of inviting defaults or adapting our economy to repayments in goods and services. In the final analysis our willingness to accept imports will depend upon our ability to maintain a high level of employment and income at home without depending upon foreign trade. If, by our domestic policy, we maintain maximum production and employment, we do not have to fear foreign competition; there will be no need to force sales abroad in order to relieve unemployment at home. For foreign trade will then cease to be a way of providing jobs and will become instead a way to obtain more of the things we need to raise our own standard of living. Here Adam Smith's advice still holds good:

> If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage. . . . In every country it always is, and must be, the interest of the great body of the people to buy whatever they want of those who sell it cheapest.

If we accept the view that international trade should be on a give-and-take basis, giving everybody a chance to do what he can do best, we cannot look to net export sales as a long-run use for savings.

Alternatively, we may approach the savings problem from the opposite direction by attempting to increase spending so that savings will be reduced. One way is by facilitating loans to consumers, including installment loans, for the purpose of buying goods and services. By liberalizing the terms of consumer or installment credit, spending can be expanded. But this is also a temporary expedient—a mere booster shot for the national economy. It has its limits, since a healthy growth

of consumers' loans can proceed at only a very moderate rate. Loans certainly cannot be expanded continuously out of proportion with total income, even though that may seem possible in prosperous times.

We can better realize the magnitude of the job ahead if we roughly estimate the amount of savings which may have to be put to use in the future, if we are to maintain a full employment level of income. Suppose, for example, that in the 1950's business is profitable, we have no sustained unemployment, and the potential national output is $200,000,000,000. Two hundred billion dollars of output will create $200,000,000,000 of income for consumers, business and government. The question then is: Will demand be great enough to provide a market for this output? If a full employment level of income is to be maintained, $200,000,000,000 must be returned to the expenditure stream. With a gross national product of $200,000,000,000, national income might be somewhat above $170,000,000,000 and incomes received by individuals might approximate $165,000,000,000. If individuals paid $20,000,000,000 in personal taxes, they would have $145,000,000,000 left. If they spent no more than $130,000,000,000 for goods and services, they would have as much as $15,000,000,000 of individual savings. To these individual savings must be added business savings, including reserves for depreciation and other purposes, as well as retained earnings. Business savings may amount to from $15,000,000,000 to $20,000,000,000. If these total savings of $30,000,000,000 to $35,000,000,000 were not matched by an equal volume of expenditures, total expenditures would fall short of income received. Markets would no longer be large enough to sustain the income level, production would fall off, until at a lower level of income and employment the total amount spent for consumption and investment became sufficient to return the total income to the expenditure stream.

We can also look at the problem from another angle. Suppose, for example, that in the 1950's expenditures of Federal, state and local governments for goods and services amounted to $35,000,000,000 and that consumers' expenditures totaled $130,000,000,000. To achieve a $200,000,000,000 level of output the volume of gross investment required would be about $35,000,000,000. Annual private expenditures for housing construction cannot be expected to exceed $5,000,000,000, once a housing boom has cared for accumulated demand. No more than $2,000,000,000 should be added in for export surpluses—if we assume

that this country remains allergic to imports. This $7,000,000,000 plus, say, $8,000,000,000 of replacement investment would leave $20,000,000,000 to be spent for new investment in plant and equipment and on inventories. Prior to 1946 private business made its highest capital expenditures—a little less than $15,000,000,000—in 1941, but the average from 1929 to 1940 was approximately $6,500,000,000. Of course, the absolute magnitudes of prewar investment have little significance in the postwar period because prewar years have now become obsolete as a measure of our future requirements. For the future we shall have to spend far more on private investment than we have on the average in the past, if we are to maintain a satisfactory national income under our private enterprise system.

If, say, $10,000,000,000 of the needed $20,000,000,000 for new investment in plant and equipment and inventories were not spent, total expenditures would not only fall short of $200,000,000,000 by $10,000,000,000, but by considerably more. When the earnings of the steel worker fall, the earnings of the grocer fall and income drops on down the line. If investment expenditures fell short of the required amount by as much as $10,000,000,000, the income level might drop $20,000,000,000 or more, and substantial unemployment would result.

The first and most important way to meet the oversaving problem is to step up spending for the things that consumers want and need. There are three possible courses by which we may raise our national consuming capacity to match the increase in our national productive capacity.

1. We can cut down the need for large individual savings by assuring workers of jobs and by expanding the social security program.

2. We can increase the incomes of people in the low income groups who will spend their income, and thereby stimulate consumption goods industries and ultimately capital goods industries. This means that wage advances must be secured as rapidly as increased productivity and lower costs permit so that there will be more purchasing power to match the increased production.

3. We can decrease the amount of income withdrawn from purchasing power by eliminating social security reserve accumulation, and financing part of social security benefits out of general tax revenues, by reducing uninvested corporate savings, and by selecting taxes which least reduce the effective consuming power of individuals.

While we are taking measures to increase consumer spending we must have the imagination and courage to recognize and grasp the unlimited investment opportunities which stretch out before us. Thousands of people are yearning for electronic kitchens, television, air conditioning and dozens of other gadgets which will make the world a more livable place. The manufacture of these durable consumers' goods will call for increased plant and equipment. The development of air transport will require heavy investment. The application of science and technology to human progress will give us a whole new frontier. But new inventions are only part of the answer. They cannot provide investment outlets for all of our surplus savings, as we learned in the twenties when the production of radios and electric refrigerators was in full swing and "two cars in every garage" was the current slogan. It will be equally important to invest in the additional plant and equipment required to manufacture more of the basic necessities of life—more and better food, more and better clothing and more and better housing. Low-cost quantity production can be profitable to American industry in all of these fields. Low-cost housing, for example, long considered uninviting to private business, could become, through new construction methods, as rewarding as low-cost automobiles. There is desperate need for better equipment for farms and shops, for hospitals and schools. The possibilities of urban redevelopment are staggering. There is scarcely a big city anywhere that does not ask the aesthetic eye for demolition and reconstruction. We are not limited by the boundaries of the United States. Nearly every country in the world offers territory which we can help to develop, if we first solve our basic problem at home. That problem is to establish a mechanism by which our savings can be put to use for a multitude of urgent purposes that will create a high level of employment. Once the ground is broken, it should be possible to maintain private investment at a rate commensurate with our needs.

To the extent that these measures fail and individuals and private business enterprise do not return their savings to the income stream, the government must provide an offset to the deficiency in private spending, even if that course of action produces a deficit. The government can direct spending to useful projects in the fields of river valley development, public highways, soil erosion control, irrigation and reforestation; it can increase outlays for housing, education, recreational facilities and cultural activities. Projects of this character increase the

productive power of the country and lead to higher living standards, and the government may recover the cost directly through service charges or indirectly through increased revenues. The alternative to such fruitful projects is a transfer of money in the form of relief or public assistance. Politically, relief or assistance payments are the easiest way. Opposition to both kinds of government spending is vocal on mutually contradictory grounds. Useful projects are criticized on the ground that government would be competing with private business; direct relief is opposed on the ground that people should not be paid to live in idleness.

A deficit may be incurred not only by increased government spending, but also by reducing taxes. Tax reduction—particularly in the lower brackets—places additional purchasing power in the hands of private spenders. This has many advantages, not the least of which is that the spending has no political complications. With present exemptions and rates and the existing relationship between tax collections and national income, tax reduction can have an enormous effect in checking an incipient depression. This was not the case in 1929 when revenues amounted to only about $4,000,000,000. Then a 100-percent reduction of Federal taxes would have had considerably less effect upon the total flow of income. Today tax reduction should usually be the first recourse as an antidepression device, and increased government spending should generally be the last resort. This is especially true during periods of mild recession when it is difficult to generate public works rapidly enough to make them fully effective. However, if a more serious depression developed, it might be necessary to stimulate spending by those who pay no tax because their incomes are below the personal exemption level. Obviously, this could not be accomplished by the expedient of tax reduction.

To say that government spending for public works should be the last resort in fighting a depression is not to say that public works may not be a valuable sustaining factor in a long depression. If a depression is sufficiently prolonged, there is time to put an emergency public works program into operation. But even then public works will be only one of a number of useful devices which may serve to combat deflation. All of these devices need to be blended into a consistent program. On the other hand, public works have a long-term function at all levels of economic activity. Private capital cannot be expected to

embark upon many large-scale programs that can be undertaken by government. In addition to raising living standards generally, most public works programs have a healthy economic effect in assuring a demand for capital, a market for materials and equipment, and opportunities for employment. Public works can, therefore, be of continuous assistance in stabilizing the economy and should be regularized according to our long-term national needs.

If we face the fact sufficiently in advance that there may be a deficiency of private spending when income is being paid out at a full employment rate, and if we prepare well in advance for this contingency by planning measures to create the needed balance in our economy, ultimately there may be less need for government spending. Certainly no one would regret having overprepared for such an event. The possibility that we must depend upon government to some extent to take measures to secure an adequate level of spending does not imply that we have arrived at a mature economy. There is a difference between a mature economy and a mature approach to economic problems. A need for supplementary public investment does not imply that private investment will disappear, nor that opportunities for capital expansion will no longer exist. On the contrary, government spending, if it is intelligently planned and administered, may augment and strengthen private enterprise. In fact, it may be the only means of providing sufficient opportunities for continued private investment and capital expansion.

Book Three

A FEDERAL TAX SYSTEM FOR THE FUTURE

Chapter 27

EXCISE TAXES AND CUSTOMS DUTIES

1. *Our Present Taxes*

WE CAN hardly begin a discussion of future Federal tax policy at a more logical place than the taxes we now have. Although we have more than 100 different taxes, they can be broadly divided into six major classifications which are: (1) the individual income tax; (2) the corporation tax; (3) excise taxes; (4) estate and gift taxes; (5) customs duties; and (6) social security taxes.

The first three of these groups of taxes are the most important in terms of revenue. They also have the most important extra-revenue implications, though so far in our history far too little recognition has been given to this fact. The fourth and fifth groups have both revenue and acknowledged extra-revenue purposes; and the last group has no revenue objective in the conventional sense of the word.

Taking only revenue into account for the moment, according to estimates made by the Treasury in December 1946, individual income taxes will bring in about $18,400,000,000 in the fiscal year 1948, or a little more than 46 percent of our total revenue. Corporation taxes will add up to over $8,200,000,000, or nearly 21 percent, and excise taxes, about $6,000,000,000, or slightly over 15 percent of the total. The estimate of excise revenue yield assumes a decrease in tax rates effective July 1, 1947, in accordance with the President's declaration of the termination of hostilities on December 31, 1946. Continuation of wartime excise rates would add over $1,000,000,000 to tax revenues in the fiscal year 1948. Customs receipts, at one time our principal source of revenue, will account for only $517,000,000, or 1.3 percent; and estate and gift taxes will bring in about $730,000,000, or a little more than 1.8 percent. Employment and old-age taxes and miscellaneous items make up the rest of government receipts.

The paramount questions of future Federal taxation revolve around the individual income tax, the corporation tax, estate and gift taxes and social security taxes. But before considering these larger questions, a few observations about the two remaining groups of taxes, excises and customs duties, may be in order.

2. *Excise Taxes*

The Federal Government levies about fifty excise taxes on the privilege of buying or selling selected commodities and services and on the use of certain articles. The chief revenue producers are the taxes on liquor, cigarettes, gasoline, jewelry, transportation, telephone and telegraph, and general admissions. Some of the remaining excises, such as the taxes on silver bullion sales and machine guns and sawed-off shotguns, have no revenue purposes and yield very little revenue.

All taxes raise problems, and excises are no exception. These problems vary among excises both on the administrative level and on the enforcement level, where prevention of evasion is of paramount importance. With some excises administrative difficulties arise over what articles are taxable; with other excises the area of taxable articles may be clearly delineated, but the administrative work may be heavy because of the need for processing numerous returns and answering many questions from taxpayers.

Problems involved in determining what articles are taxable may be knotty, even in cases where the law at first sight seems definite. When the law is written in general terms, the problems may become greater. For example, the statute imposes a tax on electrical energy sold for residential and commercial purposes. An immediate question is: What is a commercial purpose, as distinguished from an industrial purpose which is not taxable? In the course of answering this question the Bureau of Internal Revenue had to decide whether there was a difference between processing milk for sale as fluid milk and as cheese, and whether hatching chickens was a commercial or an industrial activity.

Administrative problems multiply when the Bureau must deal with a large number of taxpayers who keep inadequate records or no records at all. Although these taxpayers may in no way attempt to evade taxes, it is frequently difficult for them to determine their taxable sales and for the Bureau to check their returns.

Some excises levied at the manufacturers' level, such as the taxes on

tobacco, gasoline and matches, are relatively easy to administer, both because the number of taxpayers from whom the tax is collected is limited and because most of the problems concerning definitions of taxable transactions, taxpayers and taxable sales have been solved over a period of years. Inasmuch as most administrative questions are worked out in the first few years after a tax is imposed, an old tax nearly always seems easier to administer than a new tax, although in an original sense there may be no difference between the two.

Most existing excises raise comparatively few enforcement problems, since taxpayers generally are honest and will pay their taxes correctly if they are made understandable to them. However, very strict attention is paid to the prevention of evasion of taxes on alcoholic beverages. Because of the obvious economic incentives to evasion, a large staff is used for the day-to-day administrative and enforcement activities of the Alcohol Tax Unit. The tax on distilled spirits amounts to several times the cost of producing the product. Since distilled spirits are relatively easy to produce and transport, a close watch must be kept to prevent the diversion of spirits from legal plants, as well as to prevent illegal production.

Excise taxes are closely akin to sales taxes, but they differ in that few absolute essentials are affected. Since people can to some extent avoid paying excises by reducing or cutting their consumption of the quasi-luxury items subject to tax, the hardship imposed on the low income groups is less than it would be under a general sales tax. However, the theory that excise taxation is more selective than a broad general sales tax is doubtful in specific applications. A comparison of excises with sales taxes embraces much shadowy territory. Of course, a tax upon jewelry and furs and cabarets is a lesser burden upon low incomes, and is more defensible, than a tax which reaches food and clothing and fuel. But the search for revenue leads excise taxation into territory where the squares are less black and white. A man can live without tobacco, to be sure, but tobacco is the poor man's friend, and an excise on this commodity hits where it hurts. The difference between excise and sales taxes therefore becomes almost unrecognizable at times.

Excises have two principal functions. The one which has chiefly motivated Congress in putting most of the excises we now have on the books is to raise revenue. But the higher function of excises lies in their use as an instrument to control the operation of the economy. In wartime they aid in diverting resources from the production of civilian goods to the production of war goods. They help to mobilize our

resources for war by cutting down the amount of money people can spend for less important things. In peacetime, just as in wartime, there will be periods when we need more than increased taxes on low bracket incomes to control inflation. At such times selected excises may serve the purpose, on the whole, better than a general sales tax. But in times of deflation, when the economic roller coaster takes a dip, excises may help to speed it on its downward course.

In the future excise taxes should be handled with more care than has been given in the past to this type of taxation. Clearly excises cut spending power. They take the same toll out of every dollar spent on taxable goods, regardless of the income bracket of the buyer of the goods, and their impact tends to concentrate on the lower brackets where a greater percentage of income is spent on taxable goods. Lowered spending power cuts sales of consumers' goods, and diminished sales cut down production and employment. Unemployment reduces tax revenues all across the board. It may often be a question whether an excise tax will produce a net gain in tax revenue as a whole, and whether its impact upon the economy will be more harmful than the loss of any revenue it might produce. Furthermore, excises are undesirable on other grounds. They tend to distort individual consumption patterns, and in this way interfere with production and distribution.

3. *Customs Duties*

Customs duties were the principal source of government revenue in the nineteenth century and the first fifteen years of the twentieth century, though it should not be forgotten that they have traditional purposes beyond the revenue—to foster American industry and protect it from low-priced foreign competition, to maintain a high standard of living for labor and to sustain the price of agricultural products. Today customs have been reduced to but a small fraction of their former estate as a revenue producer, so that they are hardly as important in this capacity as estate and gift taxes. Their future is problematical, but they are not on the list of important governmental fiscal supports. If we are to have a high national income and full employment, imports should increase, since part of our expanded consumption will include foreign goods. But high tariffs may defeat this tendency. In the long run, any revenue derived from customs must have charged against it the adverse effects which duties have on the volume of world trade.

Chapter 28

THE INDIVIDUAL INCOME TAX

1. *Place in the Revenue Structure*

THE individual income tax is our fiscal beast of burden. During the war it was, and for the future it should continue to be, our most important source of revenue. In 1939 we were raising about $1,000,000,000 from less than 4,000,000 individual taxpayers. Decreases in exemptions, increases in rates and a rapid rise in national income have been responsible for a marked change in those figures. In 1946 nearly 50,000,000 individual income tax returns were filed, and income tax collections amounted to more than $18,000,000,000. Expansion in these proportions is something that most people, talking in 1939, would have said could not be done. As we go forward with the job of redesigning our Federal tax structure, we shall doubtless be told that many of the things we want to do cannot be done. We shall be wise then to remember that the apparently impossible has happened before in taxation and may be made to happen again, if we have the wit and the will to make it happen.

Equity is decidedly on the side of the individual income tax. By using income as the measure of taxpaying ability, along with personal, marital and dependent exemptions, and graduated rates, the tax distributes a large part of the financial burden of the government on the basis of the generally accepted principle of ability to pay. The social and economic potentialities of the individual income tax are only beginning to be realized and explored. From these extra-revenue standpoints its influence may be good or bad. In the past its influence has been both good and bad because the tax has been imposed merely to raise revenue; other results have been accidental. For the future we may hope that it will be wisely used as an instrument to correct extreme trends in the economy.

From the administrative standpoint the individual income tax is

carrying its load largely because so much of it is collected at the source. Nearly 2,500,000 employers are acting as withholding agents and collecting for the government all of the taxes of about 30,000,000 wage earners and at least part of the taxes of 40,000,000 taxpayers with earned income. Approximately the entire tax liability through the second surtax bracket is collected by withholding from wages and salaries, and a substantial portion is collected in almost all brackets. These week-by-week, or month-by-month, deductions are a source of great satisfaction to most taxpayers because they adapt payments to their budgets and the flow of their income. They should also be a source of great satisfaction to the Treasury, since much revenue is gathered in which might otherwise be lost. Taxpayers with incomes from other sources than wages and salaries, as well as taxpayers with wages and salaries above the second surtax bracket, keep substantially current by estimating their incomes for the year and paying their tax in current quarterly installments. Almost immediately after the end of the year the vast majority of taxpayers have paid approximately the taxes they owe on the year's income.

2. *The Concept of Taxable Income*

Learned tax scholars have given much of their time and not a little of their emotion to what may be called the concept of taxable income, the base of the individual income tax. Over the years the general outlines of this concept have become reasonably clear. The income tax is placed upon net income, which is gross income less a list of statutory deductions. There is an important difference between gross income and gross receipts, or even gross accruals in the accounting sense of that term. Certain items, such as tax-exempt interest, gifts, bequests and inheritances, compensation for injuries or sickness, the proceeds of life insurance and social security benefits are excluded from gross income, either because of supposed constitutional limitations or a legislative policy of exemption. Gross income is income received or accrued less these exclusions.

Gross income is not limited to money receipts or cash income. Receipts in the form of property, such as stocks or securities, promissory notes, the value of schooling, improvements by lessees and, under certain conditions, living quarters and meals, are taken as the equivalent of cash to the extent of their fair market value. If this were not done,

the tax could be largely avoided by wholesale resort to the barter technique. The theory is that a taxpayer who receives the equivalent of cash has received something which is disposable or is of value in the same way as cash; therefore he has ability to pay and should be taxed as if his receipt were cash.

Gross income is usually reckoned on a cash receipts basis by individual taxpayers, although like corporations they have the privilege of using the more refined accrual method, which generally reflects income more correctly because it disregards the frequently fortuitous consideration of physical receipt and emphasizes the economic moment when there is a right to receive. But even under the cash receipts method physical receipt is not an essential of taxability. If it were, people could avoid the tax by simply refusing to take possession of income. Income may therefore be taxed, even though it is not yet in the owner's possession, on the theory of constructive receipt, as in the case of uncollected but collectible interest on bank deposits, uncashed salary or dividend checks, matured bond coupons and other items which can immediately be turned into income. In other words, income which a taxpayer is free to enjoy if he chooses is taxable income, whether he sees fit to enjoy it or not.

Gains from the sale of assets are also included within the meaning of the term "income." This category of income brings special problems. A mere increase in the value of property is not by itself income. The realization of income requires some taxable event, such as a sale or exchange. Tax law is filled with questions about whether and when a sale or exchange has occurred and whether one which has occurred is protected from tax by any special exemption provisions, such as the reorganization provisions.

To turn gross income into net income is a refining process. The statutory list of deductions which must be subtracted from gross income to obtain net income includes expenses incurred in creating the income. The deduction for expenses covers most business or professional expenses, including wages paid out, business insurance and rent. It also includes such items as the cost of operating automobiles for professional use and subscriptions for professional literature. Other deductions cover depreciation, obsolescence, depletion, interest, taxes (except Federal income taxes), certain types of losses and bad debts.

Personal living expenses are generally not deductible. This rule applies to rent, food, clothing, wages to household servants, life

insurance premiums and expenses of children's education. However, some personal expenses are treated as ability-to-pay deductions. Contributions not in excess of 15 percent of the taxpayer's net income, medical expenses over and above 5 percent of the taxpayer's net income, and alimony are within this exception.

The concept of taxable income is a changing concept, as it should be, but it is a workable concept. True, there is much complaint among tax lawyers and their clients about lack of certainty and the elasticity of the term "income." Some of this complaint is valid. Taxpayers should have certainty wherever it can be achieved without the loss of other more important values. Some of these other values mean more to taxpayers in the upper brackets than many of them realize when they make their complaints; and, more often than they think, those who loudly protest would protest even more loudly if income tax law lost its capacity for growth.

But uncertainties about the concept of income and the deductibility of given items are far from being the major problems of the individual income tax. In this field of taxation, as in other phases of our tax system, the most pressing problems are those which affect the masses of taxpayers. They are not primarily problems of law, but rather of economics. They are questions of policy to be answered in the light of many underlying forces in our changing economic order, some of which undoubtedly conflict with one another. In the end the solutions reached will have more than many business men suppose to do with their fate. For the wrong answer, along with other factors, may precipitate a deflation which would resolve the narrower tax questions by the simple expedient of eliminating profits. And the right answer may help to bring profits which multiply tax questions. Taxpayers who see this alternative clearly will have little trouble deciding what they prefer. They will undoubtedly choose the prosperity that brings tax questions rather than the depression that makes it doubtful whether they will have any taxable profits at all.

3. *Exemptions and Rates*

Problem Number One for millions of taxpayers is the amount of the personal exemption. Under present law the exemptions for both the normal tax and the surtax are $500 per capita, that is $500 for the

taxpayer, $500 for his wife and $500 for each dependent. Much of the discussion about increasing the general level of exemptions in the future disregards the underlying and controlling facts. The foremost fact, little understood by some people with the most emphatic opinions, is that the largest part of our national income is received by persons with relatively small or moderate incomes. Consequently, the yield of the individual income tax is predominantly in the lower brackets. It was estimated in 1945 that the 96½ percent of taxpayers with net incomes under $5,000 would pay about 53 percent of the total individual income tax in 1946. According to this same estimate, the 3.5 percent of taxpayers with net incomes of $5,000 and above would pay about 47 percent of the total. The 3 percent of taxpayers in the $5,000 to $25,000 income class would pay a little over 21 percent, and the less than one-half of 1 percent of taxpayers with net incomes over $25,000 would pay approximately 26 percent. The less than one-tenth of 1 percent of taxpayers with net incomes over $50,000 would pay slightly less than 16½ percent of the total.

Another fact, frequently overlooked, is that excise taxes, state income and state sales taxes are largely paid by the same people who pay the Federal individual income tax. To a certain extent local property and other taxes also have an impact upon individuals. The Federal income tax cannot be examined in a separate compartment. On top of the approximately $18,000,000,000 individuals paid in Federal income taxes in 1946, they paid more than $3,000,000,000 in state income and sales taxes. An intelligent decision about the level of the personal exemption and the amount of the dependency credit cannot be made without heeding these facts.

The effect of exemptions on the income tax base also calls for analysis. As a matter of fact, after the operation of exemptions, along with exclusions and deductions, a relatively small percent of national income enters into the tax base. Estimates made by the Committee for Economic Development, postulating a national income of $140,000,000,000, show a tax base of about $58,000,000,000 after subtracting $38,000,000,000 of miscellaneous income not subject to tax, $11,000,000,000 for allowable deductions of various kinds and $33,000,000,000 for personal exemptions. These figures indicate that even with present low exemptions the income tax reaches little more than one-third of the national income.

With a higher national income a larger proportion of income would

enter into the tax base. With a national income of $170,000,000,000 and exemptions at their existing level—$500 per capita—the tax base would be well above $70,000,000,000 and would reach about 41 percent of national income. With the same national income and with exemptions at the 1939 level—$2,500 for a married couple, $1,000 for a single person and $400 for dependents—the tax base would be reduced to about $40,000,000,000. An increase in existing exemptions from $500 to $600 would lower the tax base to about $62,000,000,000.

Other factors which bear upon exemptions must also be considered. First of all, is it basically fair to impose income tax upon a person whose income is inadequate to support himself and his family and who is already paying a substantial amount of hidden taxes? Apart from what is equitable, does the tax do more harm than good by cutting down the purchasing power of low income groups? There are no pat answers to these questions. Merely to say that the paramount consideration is to make everyone tax and economy-conscious is an incomplete answer. Who can guarantee that the exaction of a few dollars a year from the most unfortunate taxpayers will develop much tax-consciousness? The response may be a resentment that breeds resistance, or there may be no reaction at all. But, assuming that tax-consciousness is a valuable by-product, it may still be too costly in terms of purchasing power. If low exemptions and a widespread tax on the lowest income groups curtail spending dangerously, the price of tax-consciousness, at least at certain times, will be too high. As a part of any intelligent analysis of the problem of the level of personal exemptions and dependency credits, this effect must be taken into account.

Problem Number Two of future individual income taxation centers on rates. Here again we must start with the facts, principally the pattern of income distribution in the country. As we have seen, the bulk of national income is in the lower and middle brackets. Generally speaking, the people in the lower brackets have a high propensity to spend; those in the higher brackets have a strong tendency to save. By their spending the lower income groups keep the wheels of industry turning; by their saving, if it is not excessive, plus their willingness to invest—especially in risk ventures—the higher income groups provide funds for the expansion of the economy.

The rub, of course, is that we need revenue and we must obtain it from either the spending or the saving class. But when we tax people

who spend, we reduce purchasing power. And when we tax people who save, we diminish both the available funds and the incentive to invest. In the one case we curtail markets; in the other we may deter expansion. True, both nonventure capital seeking conservative outlets and venture capital willing to take risks may be in the same taxable income brackets. But the basic problem of tax rates—to achieve a synthesis of two apparently irreconcilable forces—remains. What rates then will be most conducive to spending and at the same time give the greatest encouragement to risk-taking? There is no facile or enduring answer to that question. Rates which are well-advised at one point of time may be ill-advised at another. But recognition of this inconstancy may be all to the good. For once we learn to adjust tax rates to shifting economic conditions, we shall have gone a long way toward controlling runaway booms and preventing depressions.

The determination of individual exemptions and rates requires many different choices, but one or two truths are self-evident. If we would keep the income tax the backbone of our tax system, depending primarily on it for revenue, we must have a broad base. But the base should not be so broad that too much is taken from the lowest incomes. Our destination at least should be little or no tax upon those who must pay taxes out of money that is necessary for the minimum food, clothing and shelter their families need. However, the matter goes far beyond the realm of equity. The repercussions from the diminished spending, which would result from taxing low income groups too heavily, would be felt throughout the income scale in terms of reduced markets, unemployment, falling profits and, perhaps, losses. The self-interest of all of us calls for exemptions high enough and rates low enough to insure the volume of spending necessary to maintain the employment levels and living standards the nation must have.

At the lowest end of the income scale some of the undesirable effects of a broad base may be mitigated by a more refined rate structure. Estimates made in 1945 indicated that the first $2,000 surtax bracket covered about 89 percent of the taxpayers. They have the same marginal rate of tax on their income without any rate progression; there is, of course, some progression in the effective rate because of the operation of the exemptions. But the principal progression in our rate structure now lies in the twenty-three brackets above $2,000 which cover only about 11 percent of the taxpayers.

At the upper end of the income scale we are relieved of revenue pressures. Income taxes in the highest brackets contribute relatively little revenue at the present time. At the upper levels even 100 percent taxation would make no more than a dent in a $30,000,000,000 budget. Total revenues would be little affected by rate reductions in these brackets. On the other hand, high taxes at the top of the income scale are an intrinsic part of a progressive rate structure. The people with high incomes can best afford to contribute to the support of the government, and failure to impose substantial taxes in the upper brackets would seriously injure the morale of the rest of the taxpaying public. Moreover, while spending by the high income groups is relatively insignificant, high taxes on these groups perform the valuable service of preventing more saving than our economy can absorb.

The valuable services performed by high rates in the upper brackets should not blind us to the necessity of preserving the incentive that is necessary to keep some of our ablest citizens at work. Rates in those brackets can be too high for an economic system which depends upon the profit motive. They should be kept at a level which enables some accumulation of protection for wives and dependent members of families and fosters economic activity on the part of the producing members. The need for this incentive probably stops when we reach the highest brackets. A rate schedule which rose more gradually up to about $200,000 and then rose very sharply might be worth trying in order to observe its effect upon the industry of those who received the benefit of less sharp graduation.

The question of appropriate rates for the great middle class remains. A considerable amount of revenue is derived from taxpayers in the middle brackets; at the same time these taxpayers provide a fair share of risk capital. A selection of rates, therefore, involves a choice between the devil and the deep blue sea. Rates must not be so low that revenues are too greatly affected, nor so high that enterprise is unduly curtailed. There is room for reduction below wartime levels, but I am sure that the correct rates are higher than will be popular even with more liberal loss provisions and other expedients to prevent hardship. At this time no great purpose is served by stating an exact scale of rates. I cannot go much farther than to suggest the attitude that should control. All of us are primarily concerned with disposable income—the money we have left after taxes. If high taxes help

to keep the economy running in high gear and leave the people in the middle brackets with more money to spend in the long run, they are a boon, not a burden. They will not destroy the great middle class; on the contrary, they will help it to survive.

We should be on guard against the notion, implicit in much tax propaganda, that the panacea for all our economic ills is rate reduction. Here history may furnish suggestive lessons. Depressions did not originate with the income tax. One of the remarkable phenomena of our time is the convenient ease with which many of us forget the depression that began in 1929 and its chronological relationship to a previous extended period of rate reduction. On the other hand, we have had two periods of great prosperity—during World War I and World War II—accompanied by high tax rates. All this may not prove that a particular level of taxes—high or low—will either bring prosperity or induce depression. What we must recognize, however, is that tax reductions are desirable when the economy is depressed and tax increases are desirable when the economy is booming. Taxes are only one of many factors entering into the economic equation. They are, or can be, a powerful instrument for stabilizing the economy. But they cannot do the whole job, and we shall not reach or maintain a high level of employment and national income by the mere expedient of tax reduction.

One final factor of taxpayer attitude bears directly on the question of rates. Under 1945 law the normal tax is 3 percent and surtax rates range from 17 percent on the first $2,000 of surtax net income to 88 percent on incomes over $200,000 with a top effective rate of 85.5 percent. The combined normal tax and surtax are further reduced by 5 percent of the tax, making the starting rate 19 percent and the top rate 86.45 percent. In bemoaning high taxes, taxpayers commonly talk in terms of marginal rates, or the upper end of the rate schedule to which they are subject. Except in the very high brackets actual average rates, or effective rates, are much lower than marginal rates because of graduation and personal exemptions. The effective rate is the percentage of net income which is paid in taxes. For example, a married man with net income of $1,500 before personal exemption is subject to a marginal tax rate of 19 percent, but the effective rate is only 6.3 percent under the Revenue Act of 1945. In the same circumstances a man with a net income of $50,000, who sits in his club and talks about paying

68 percent of it out in taxes, is stretching a fiscally elastic term. For the effective rate of his tax is actually about 49 percent. Under 1945 law people who are subject to withholding think of their tax rate as 19 percent and people fortunate enough to be in the top bracket think of their tax as 86.45 percent. They would be happier and more accurate if they learned to think in terms of effective rates.

Chapter 29

CAPITAL GAINS AND LOSSES

SOUND results in taxation are not always achieved in direct proportion to the number of words that are spoken and written on a particular subject. Sometimes the opposite may be true—as, for example, in the case of the treatment of capital gains and losses. Reams have been written about capital gains and losses, and for three decades they have been the subject of almost constant debate. Today they still pose an unsolved problem.

Before 1922 capital gains were taxed in the same manner as any other income. Since 1922 our tax system has distinguished between capital gains and other income. From the beginning of the income tax various differentiations between ordinary losses and capital losses have been attempted. There is, of course, another possible method of treating capital gains and losses, and that is to ignore them altogether. This is what the British are somewhat inaccurately said to do.

Why should capital gains be treated more favorably than any other kind of income? Advocates of special treatment have one good reason for their stand and several other reasons which weaken under the light of careful scrutiny. The good reason applies to gains which have accrued over a reasonably long period of time—at least more than a year. Realizing a gain in a single year bunches in that year income that has accrued over a longer period, so the tax is higher than it would have been if the gain had been taxed bit by bit as it grew. Progression in the rate structure causes this inequity, and the inability to offset losses incurred in another period aggravates it. It is no more than fair that the tax on a gain which has accrued over more than a year should approximate a year-by-year tax as the gain accrued. The present preferential treatment of sales of property held for only six months runs counter to this reasoning; obviously, the binding argument calls for a

holding period of more than a year. A longer holding period might also be used to check speculative trends.

However, apart from the limited capital gain period, the "bunching" line of reasoning is only partially sound. It is based on the premise that gains accrue ratably over the period of ownership of an asset. That is not always true. It may be true of an evenly developing real estate gain, or a stock gain arising from the steady accumulation of profits in a corporation. It is not true of a real estate gain that arises from a sudden community boom, or that stems by chance from some local improvement. It would not be true of many stock gains which reflect abrupt new expectations of enhanced future profits.

Nevertheless, it is probably true that a large proportion of capital gains do accrue gradually, if not evenly, over the period of ownership, and there is much rough justice in extending to them a tax treatment which avoids the effect of an artificial concentration of taxable income in one year. The Revenue Act of 1934 applied this theory more consistently than other acts embodying special preferential treatment for capital gains. It provided for taxing capital gains according to the length of time the assets had been owned; the longer the period, the lower the tax. No special treatment was available until an asset had been held for more than a year. Whatever its faults, this provision had much in its favor from the standpoint of equity.

Another argument for special treatment, frequently advanced, is more vulnerable. The contention is that capital gains merely reflect a general rise in the price level, so there is no real increment at all in terms of purchasing power. They may be no more than a manifestation of inflation. Therefore, say the advocates of special treatment, capital gains are illusory. But this argument proves too much. Price fluctuations affect all kinds of income. They affect the purchasing power of wages; the ability to pay taxes varies with the cost of living as well as with the absolute amount of wages a worker receives. An increase in wages may reflect nothing more than a rise in the price level; it may be just as illusory as some capital gains. No tax law can do absolute justice all along the line in an economy of shifting dollar purchasing power.

The impossibility of doing absolute justice is not a valid reason for failing to do justice that can be done. A perfectionist is a dangerous man in the tax world, which is full of things that need to be done only

as well as they can be done. But one problem recurs too frequently to be neglected any longer. It can be illustrated by a simple case history.

In 1915 Mr. Smith came to Washington to work for the government. He bought a house for $5,000. In 1945, after he had devoted thirty years to government service, he was ordered to Chicago. He sold his house for $15,000 and moved his family. Plainly he had a capital gain of $10,000. But Mr. Smith was spoiled; he liked to own his home; moreover, in Chicago he could find no apartment at a reasonable rental. So he bought another house. It was no better than the one he had sold in Washington, but it cost him $15,000, exactly the amount he had received for his Washington house. The amount he had received, yes. But not the amount he had left in his pocket. The government had part of the first $15,000, and Mr. Smith had to dip into his savings to pay for the second house.

Mr. Smith's tax lawyer told him that he had no recourse. But if Mr. Smith had been in business and his house had been a ship which was requisitioned by the government for $15,000, the advice would have been different. Then he would have had an "involuntary conversion," and he could have established a fund with the first $15,000 to replace the ship. Then he would have had no taxable gain, and the $15,000 would have been in his pocket and available to buy the second ship. In practical fact, although not technically under the law, Mr. Smith had an involuntary conversion. He had no choice but to go to Chicago. It is hard to see why he should not enjoy the financial position in Chicago that he had in Washington.

There are thousands of Mr. Smiths in government and in business. Never were business conditions so chaotic as today, and the geographical shifting of personnel required both by business and government did not end with the war. If Mr. Smith were politically minded, he could make a strong case for tax relief. But he is just an ordinary citizen, so he takes his medicine. It can be added that the income tax is not popular in that house in Chicago. Mr. Smith might pay his other taxes more willingly if he thought he had been fairly treated.

Of all the reasons urged for eliminating or reducing the capital gains tax, the lamest is that we should emulate the British. It is true that in England gains from transactions which partake of the nature of the taxpayer's regular trade or business are taxed at regular rates. Only "casual" gains are exempt, and the British Income Tax Act of 1945

narrowed this area of exemption. Moreover, these exempt transactions are relatively less important in Great Britain than they are here. But even more significant is the fact that the British system permits serious tax avoidance, and for that reason it has been condemned by eminent British tax authorities.

The theory is frequently voiced that profits realized over a period of time from investment in securities or property should not be taxed in the ordinary way because to do so would have a deterrent effect on risk capital. So, it is urged, the capital gains rate should be lowered, or the tax eliminated, as an incentive to business. Critics insist that the tax has a "chilling effect" and "checks risk-taking," and that its repeal would "free venture capital." Stated in more exact terms, rather than catchwords, the argument takes two forms: first, the capital gains tax checks investment and, second, the tax checks selling investments with unrealized gains and thus restrains capital from going elsewhere.

Arguments for special treatment of capital gains, based on the assumption that concessions in this direction would stimulate business activity, fail to face the choice before us. Practically every tax has some effect on the willingness of investors to risk their capital in hazardous enterprises, which, of course, is a different kind of risk from that which prompts sheer stock speculation. The reduction of other taxes might have a more stimulating effect, particularly a reduction that brought about a greater increase in mass consumer purchasing power and thereby exerted a salutary influence upon business activity. The choice is complicated, but the answer hardly lies in making risk-taking entrepreneurs the darlings of the American economy at the expense of the rest of the public.

Some people even go so far as to say that the elimination of the capital gains tax would stop depressions. This is extremely dubious reasoning. We had depressions before we had the tax. England does not tax "casual" capital gains and it has depressions.

It is also argued that revenue would be increased by repeal or reduction of the tax, since market activity would be stimulated. The idea is that the tax is a barrier to selling, especially in the case of older investors who will be able at death to pass on their gains tax-free. Congressional committees have been wooed with extravagant estimates of increased revenue yield. These claims, however, oversimplify the problem. Many causes contribute to the yield of a tax on capital gains:

the level of the market, anticipation of future prices and future taxes, the cost of assets in the hands of the holders, the distribution of assets by income brackets and the extent to which individuals holding assets with gains also hold assets with losses. The method of taxing capital gains is only one of many factors affecting the amount of gains realized. Variations in capital gains revenue have been determined primarily by changes in stock prices rather than by changes in tax methods.

It is also necessary to distinguish between long-run and short-run revenue effects, and between the direct yield from the capital gains tax and its indirect effects. The tax is designed not only to raise revenue directly, but also to prevent the avoidance or minimization of other taxes. Under present law ordinary income can be converted into capital gains by allowing profits to remain in corporations. As a matter of fact, the tax can be wholly avoided by holding stock until death or, to some degree, by making gifts of property which has appreciated in value. While some doubts have been raised as to its constitutionality, I believe that the most promising remedy for avoidance of this type is to impose a tax upon gains accrued to the date of any gift of the stock or at the time of death. I believe that such a tax would be upheld.

Finally, it is useful to know who realizes most capital gains. About 80 percent of capital gains and a slightly smaller percentage of losses come from stock market operations. In 1938, a fairly typical year, capital gains constituted less than 1 percent of the net income reported by persons with incomes under $5,000, about 3½ percent of the net income of persons with incomes between $5,000 and $25,000, and about 11 percent of the net income of persons with incomes over $25,000.

Capital gains compose a larger portion of income, the higher the surtax bracket. The income class from $100,000 to $1,000,000, for example, reported in 1938 only about 2½ percent of aggregate net income, but it reported nearly 19 percent of capital gains. It is plain to see that the preferential rate for capital gains seriously interferes with the progressiveness of the income tax. Obviously, a more favorable treatment of capital gains would interfere further by benefiting primarily a small high income group.

And what of capital losses? Existing law limits the right to deduct losses from ordinary income in various ways. Some taxpayers think that the government is guilty of sharp practice in taxing their gains in full and refusing to give the same consideration to their losses. If

capital gains were taxed in full, there would be no justification for any such limitation. But the favored treatment of capital gains, plus the fact that the timing of both gains and losses is largely decided by the taxpayer, affords considerable justification on grounds of equity.

However, the problem goes beyond strict considerations of equity. The question of risk-taking is relevant. It is quite possible that the gain to the economy to be derived from increased risk-taking would be worth more than the revenue loss involved in some reasonable averaging devices, the extension of the carry-forward period for losses, and a less discriminatory treatment of capital losses.

Chapter 30

TAX AVOIDANCE

In every country and in every age, one of the principal problems of government has been tax avoidance. Like most problems it has its psychological and semantic overtones. E. R. A. Seligman defined taxes as "compulsory contributions levied to defray the expenses incurred in the common interest, without any reference to particular advantages accruing to the taxpayer." Dictionaries tell us that the word "tax" means an "involuntary charge," an "exaction," a "forced contribution" to government. One dictionary lists the word "tribute" as a synonym. Though this concept of taxes may spring from some pre-existing attitude, no doubt cause and effect are sometimes around the other way, so that our attitude is the product of our concept. In tax law, as well as more generally in life, nature sometimes imitates art.

The American attitude toward taxes has sometimes taken violent form, as in the days of the Whisky Rebellion and the Boston Tea Party. But in these days, and for that matter usually, avoidance typifies the more subtle reaction of a more complicated society which seeks to escape the tax burden without the risk of physical combat. However, the risks taken by modern avoiders are often substantial, and dislike of taxes is not less than it used to be. It will be a long time before we have a large percentage of citizens like Mr. Justice Holmes, who told his law assistant: "I like to pay taxes. With them I buy civilization."

When Mr. J. P. Morgan said in 1937 that a man is a "fool" to pay taxes the government does not know enough to collect, he was commendably frank. Perhaps he also revealed himself as an exceptional man. Few taxpayers are quite comfortable with the knowledge that they are failing to contribute their share of the "expenses incurred in the common interest." To achieve comfort many taxpayers resort

to elaborate processes of rationalization. Sometimes they assert that they would be glad to pay taxes but for the fact that the government is in the habit of wasting money, or that it has too many collateral social activities or that the Federal Government mixes too much in the affairs of the states. Sometimes they exalt their aversions to greater heights by assuming that they are shared by the Constitution of the United States. In these instances they are prone to denounce a particular tax as a capital levy. Other taxpayers complain that the law is not certain, and argue that a government which fails to produce certainty should suffer the consequences of uncertainty. In this criticism there is a note of wistfulness and nostalgic objection to the dynamic quality of modern tax law, the very quality that is most vital to its adaptation to the many varying economic and social conditions in which tax law must live today.

Most of these rationalizations hardly rise to the dignity of argument. On the conscious level they are, of course, frequently sincere and well meaning. But they reveal a lack of maturity which should awaken profound misgivings as to the future, not only of our tax system, but also of the entire American economy. The concept that we are the products of our civilization, and not a wonderful self-made job, is little developed in most of us; the result is a deficient sense of debt to society and little intelligent interest in fostering conditions that are requisite to satisfactory living. A moment's reflection would convince most of us that taxes are an important factor in producing these conditions. From either the conventional view that taxes are for revenue only, or from the more enlightened view that they have functions far beyond the revenue, satisfactory living has its inevitable tax cost.

Tax avoidance is intimately associated with tax rates. Modern avoidance made its debut in 1917 when World War I stepped up individual rates to 67 percent and corporate rates to 6 percent plus an excess-profits tax with top rates at 60 percent. But the climate of patriotic opinion was against avoidance during World War I and it made a slow start. Then rates went down gradually until the top surtax and estate tax rates reached the delightful level of 20 percent in the twenties and tax avoidance lost much of its flavor and meaning.

Life became real and earnest in the thirties. Rates mounted; the 20-percent top surtax rate of the 1926 and 1928 Revenue Acts became 75 percent in the 1936 Act. The fact that the government desperately

needed revenue failed to temper the desire of many to avoid. Nor did lack of success. Stakes had risen, and everybody was playing for keeps. The game had passion in it.

The late thirties, following the exposures of evasion and avoidance in the 1937 investigation, were unhappy days for those who would escape the role of taxpayer. The Treasury, Congress and the courts were becoming depressingly oblivious of the necessity of accumulating a fortune and of saving accumulated fortunes from the clutches of the tax collector. The Constitution, always a fickle friend, walked on the other side of the street. The tax avoider was an outcast whom few in authority understood. The Treasury had become heartless. Court opinions continued to treat with verbal deference the ancient doctrine that everyone had a right to avoid taxes by legal means, but decisions went the other way. The Congressional ear grew more and more deaf to pleas for relief even when their phrasing was most euphonious and artistic. The avoider had few places in which he could find the sympathy he craved.

World War II brought the prosperity which had been elusively around the corner for so long. The defense boom of 1940 and 1941 poured a golden stream across the land. Even better years followed. But all was not gold that glittered. Tax rates rose to new highs in 1943. A 90-percent rate proved to be a powerful stimulant to ingenuity. Time and again Congress had hoped it had disposed of the problem of avoidance. But the market had never buzzed with so many schemes as in 1943. Never had the business been so grim. Never had the schemes been so bold.

For example, in the *New York Times* of October 31, 1943, there appeared an advertisement under the heading EXCESS PROFITS TAX SAVINGS OPPORTUNITY. It read: "For Sale. Stock of corporation having 1943 tax loss deduction $120,000. Sole assets are $80,000 in cash and equivalent." In *The Wall Street Journal* of July 15, 1943, another singular advertisement appeared. It read: "Wanted. To acquire all the outstanding stock of a corporation with original invested capital of several hundred thousand dollars with present assets at nominal values." These advertisements may have baffled the uninitiated reader, but they were perfectly understandable to a small interested public. The first offered to sell the tax loss of one corporation; the second offered to buy the high invested capital of another corporation. Neither could be used

unless it was transferred to a corporation with profits. At least some tax-avoiding devices were now being peddled in broad daylight.

Tax avoiders had also learned a new technique. They could not expect too much of the Treasury which needed more than it could get. They no longer expected courts to interpret tax statutes literally in their favor; courts had acquired a new habit of searching for the underlying policy of a statute. The tendency might be called "judicial legislation" at Bar Association meetings, but this emotion-releasing epithet hardly reached the unacademic world outside. Congress was the only port in a bad storm.

In some instances another factor intervened. A zealous Treasury and a conscientious Justice Department undoubtedly tried to carry some statutory provisions, and some court doctrines, too far. Conversely, the Treasury declined to carry some relief provisions far enough. This attitude was not always a fixed or settled policy emanating from the top. The Treasury, at least, is a vast decentralized organization, and its representatives and those of the Justice Department must argue in ninety or more district courts, the Court of Claims and in a Tax Court of sixteen individual members who sit in most large cities of the country. Appeals are argued by representatives of the Justice Department all over the United States in ten circuit courts of appeals, the United States Court of Appeals of the District of Columbia and the Supreme Court. It is natural that uniformity should be less than complete. Sometimes an ardent advocate, desirous of winning his particular case, pressed too far—farther than was discreet—and sometimes he won when from the general standpoint he might more wisely have lost, so that the Treasury had to ask Congress to undo the work of its advocates in court.

On March 3, 1942, the Secretary of the Treasury coupled his recommendation for the elimination of "special privileges" with a plea for the elimination of "hardships on taxpayers." A promised administrative relief bill had been postponed. With rates at the recommended levels such a request was almost overdue; a hardship of ordinary proportions in normal times might ruin taxpayers subject to wartime tax rates. Congress listened attentively, and the 1942 Act set a record for relief. The list of relief provisions in the 1943 Act was not so long, partly because several provisions were excluded in the last days of the conference committee deliberations, but its roster of special privileges was one of the factors which moved the President to veto the bill. The

two acts amply demonstrate the possibilities of the new approach of taxpayers to the problem of tax relief. What the courts may do only in retail, Congress may do in wholesale.

Two aspects of this new approach to avoidance are significant. First, taxpayers are no longer depending upon a generous interpretation of general statutes. Those who fare badly in the Treasury and the courts are moving to the fountain of authority—the legislative branch of government. Second, many taxpayers are acting in groups rather than as individuals. Usually in the Treasury, and almost always in the courts, taxpayers act for themselves alone. Those who are similarly situated must abide by the result; incidentally, of course, they sometimes benefit from the result. But an association or group can present a united grievance to a Congressional committee more easily than to the courts. United presentations are sometimes made to the Treasury, but frequently only as a preliminary to a later presentation to Congress.

Arguments before Congress are in a sense more limited than arguments before the courts. There is a difference between going before Congress and going before a court which interprets a statute passed a number of years ago. It is impossible to say to Congress itself as you may say to the court which cannot change the statute: "Whatever Congress might have intended, this is what it said. It failed to legislate to prevent what I have done. I am within the law."

When taxpayers address Congress, the process is different. Argument becomes propaganda and pressure is often applied. Those who address Congress must be ready to mold the legislative intent. The intent is still to be formulated and the statute has still to be written. Congress may say what it wants. Merit is not always conclusive and the process may become a scramble that is anything but dignified.

These developments add up to the conclusion that avoidance has a second front in Congress. In the meantime the old judicial front remains active, and the second front gradually merges into the first. Statutory language is frail, and the relief provision, like every statutory provision ever written, eventually needs interpretation. It may mean more or it may mean less, depending upon what the Treasury and the courts say that it means. And the provisions of a taxing statute, even—perhaps especially—provisions to prevent avoidance, develop loopholes. Resourceful counsel ponder, and new schemes march to town.

One of these new schemes, for example, is a simple but ingenious

method of lowering an employer's salary expense without reducing the employees' income. This device is similar to the plan adopted by certain international organizations, such as the United Nations and the International Bank for Reconstruction and Development, of assuming the Federal tax liability of their employees. Instead of paying an employee his stipulated annual salary, the employer agrees to pay him in the taxable year only the amount of salary that is left after Federal income tax, and to pay him early in the following year the amount of tax he is required to pay on the smaller sum. Inasmuch as the amount of tax paid to the employee becomes income, most of the saving to the employer occurs in the early years of the plan. If an employee has income other than salary income, the plan results in tax saving to him by placing him in a lower and more comfortable surtax bracket. In due time this and other practices must have their day in the Treasury and in court. Mortality is high, but there are survivors.

In 1937, when Mr. Morgenthau asked for quick action to prevent the growth of vested interests in tax-avoidance devices, his foresight was better than he could have known at the time. The latest argument is that it is unfair, even when the purpose is to prevent tax avoidance, to make new law for the future affecting persons who, in the past, have committed themselves to a given course of action from which there is no retreat in the face of legislative change. The argument is, of course, one of policy. It could hardly be based upon any benevolent protection afforded by the Constitution, for in many instances the Supreme Court has held that tax liability may be redefined for past years.

The contention has been carefully stated, and its exact terms should be noted. It is not an argument against retroactivity. There is pretty general agreement that retroactive legislation is unfair except where relief is intended, or where a particularly palpable situation has reared an ugly head. The argument is rather that taxpayers have a right to rely upon the law as it is, or as they conceive it to be—sometimes without much basis—and that an irrevocable act in the orbit of existing law is entitled to protection for all time to come. It would be unfair or inequitable, it is said, to upset the legal consequences of an act of bygone years which cannot be undone. The thought, if not always the word, is that the taxpayer has a vested interest in legislation on the statute books when he embarks upon a legal journey from which there is no returning. The argument goes even further and urges that a

taxpayer has a vested interest in his interpretation of outstanding legislation, provided it is shared by a sufficient number of people at the time he acts. There is a special sense of outrage when the Supreme Court has approved the interpretation under which the taxpayer presumably acts and later exercises its ability to correct itself, not only as to the future, but also as to the past. To paraphrase a statement by Mr. Justice Cardozo, the picture is often one of a bewildered taxpayer, lured into a course of action by the false light of his own or another's interpretation of a statute, only to meet ruin when that light is extinguished. This picture, the Justice said, is for the most part "a figment of excited brains."

The argument calls for analysis before it has too many consequences. Tax statutes never have been static. New needs, developing philosophies and experience inevitably produce constant change. We live under a system of laws made by Congress and interpreted by administrative agencies and the courts. Both consist of men, not machines, who differ widely in their opinions. Some, perhaps too much, change occurs in the process of interpretation. But the Treasury and the courts may not legislate, except interstitially, and Congress must sometimes come to the rescue of an inadequate statute. Have taxpayers a right to commit themselves to courses of conduct on the theory that Congress may never in fairness change the applicable law? May taxpayers assume that Congress' hands are tied as to future tax consequences of past acts? This is a very different thing from changing consequences for past years. It is a large moral claim to say that a taxpayer commits the government to inaction for years to come with respect to acts performed in the light of supposed existing law. The argument is that the government may not change the law in its favor, but that taxpayers may urge Congress to change the law in their favor.

It would be disastrous if the government were prevented from profiting by experience and meeting its problems with new laws. Immunity today should no more guarantee immunity tomorrow than a low rate of tax today warrants a low rate of tax tomorrow. A tax statute is not a contract, immutable as the laws of the Medes and the Persians. Yet in essential outline when many taxpayers object to new legislation, they are really demanding that the past should be eternal for their sakes.

I believe that a very different doctrine should control. Taxpayers in their every act should take notice, not only of the law's *present* com-

mands, but also of its possible *future* commands. Congress should always be at liberty to attach new consequences to old acts. Generally, the new consequences should perhaps not attach retroactively to past years, but that is a different matter. That depends on the circumstances. But for future years the taxpayer should have to take his chances; he should always be obliged to act at his peril. It would be unfortunate if he could freeze the legislative, or even the administrative and judicial, process. There is no immunity from change. There may be a curse in this fluidity; if so, it is one that tax law must bear, or, as Mr. Justice Cardozo once warned in a broader context, "other curses yet more dreadful will be invited in exchange."

Chapter 31

TAX EVASION

So FAR we have been considering the philosophy underlying methods of avoiding taxes which, in most instances, have some color of legality. Once the line of legality is crossed, avoidance becomes evasion without protective coloring. Verbalists have struggled for years to draw the line which distinguishes tax avoidance from tax evasion. Both flourish when rates are high and people are resentful of what they consider "confiscatory" taxation. But avoidance is essentially a sophisticated high-bracket game, while evasion is a crude method of tax dodging practiced in all economic strata.

The ways of evasion are devious. Some evaders simply fail to keep any records or to file any tax returns; others chisel by omitting or understating various items on their returns. Still others make a practice of padding purchases and understating sales. One of the commonest and least imaginative methods is to conduct business transactions in cash so as to avoid the telltale evidence of checks and bookkeeping records. In fact, there is scarcely a type of business today which does not use currency to conceal income. A variation of the cash-on-the-line method of concealing sales is the cashing of checks through check-cashing agencies or currency exchanges, rather than banks. Most of these agencies endorse their checks in a manner which obscures the fact that they have been cashed by check cashers. The more creative evaders resort to elaborate legal and accounting devices and often go to great lengths to falsify records in an effort to cover up their tracks.

Because the use of currency is so frequently a factor in tax evasion, since June 1945 the Treasury has required banks and other financial institutions to report currency transactions of an "unusual" nature. This order is aimed at transactions involving $1,000 or more of currency in denominations of $50 or higher, or $10,000 or more of currency in any denominations.

To thwart evaders who deal in currency two measures have been suggested. The first is to call in all bills of large denominations. The second, and more drastic, proposal is for the Treasury to be authorized to open safe-deposit boxes. The latter method is, of course, open to the serious charge that it is an invasion of individual privacy.

A notable weakness of many evaders is an ostrichlike tendency to hide their riches and yet live in a style in which their reported income could not possibly support them. Activities of this nature are an open invitation to the Bureau of Internal Revenue to examine the free spenders' tax returns. Stables of racing horses, fabulous jewels and expensive fur coats are hard to reconcile with modest incomes. And the man who pays for a carton of cigarettes with a $1,000 bill is immediately suspect.

One method of evasion which has acquired some vogue among business firms is to pay salaries and bonuses to certain employees in currency. The actual amount paid may be only a small fraction of the sum recorded on the corporation's books. The balance is refunded to the company or its officers.

Customer co-operation is essential to a scheme whereby a dealer bills manufacturers for merchandise which is not delivered. The fictitious invoices are paid in due course; the dealer cashes the checks, retains a "commission" and turns over the remainder to the corporate officers for their personal use. A variation on this theme occurs when a company borrows money from customers from whom it purchases materials. As these loans are repaid, they are charged on the company books as purchases. In some instances, fur coats, pianos and diamonds are also charged to the purchase of raw materials or factory supplies. In other cases, the wages paid to the officers' household servants, and other personal expenses are included in the business expenses of firms. Still another device is to pad purchases by issuing invoices on the billhead of a co-operative contractor. Checks are cashed by the contractor and the proceeds are turned over to the company perpetrating the fraud.

During the war, as profits grew, evasion schemes became more pretentious. A subcontractor might purchase machinery, tools and dies at a cost of perhaps $75,000 and set this material up on the corporation's books at an arbitrary value of, say, $4,000,000. A fictitious liability account would be credited with the $4,000,000. The corporation would

then charge a 10-percent rental expense, or $400,000, and credit this sum yearly to the president. The original $75,000 used for the purchase of machinery would be falsely charged to an expense account on the corporation's books. Operations of this character were used by individual contractors to evade as much as $500,000 in corporation income taxes over a three-year period.

In the jewelry business various methods have been used to evade payment of excise and individual income taxes. Some jewelers merely fail to record all sales. Others resort to such chicanery as accepting currency for down payments on valuable gems, pocketing the money and reporting as income only the remainder covered by the customers' checks. This technique calls for two sets of invoices. The true selling price is listed on the original invoice presented to the customer; the duplicate is concealed or destroyed and a fictitious invoice is used for recording. Still another variation is the practice of inflating the cost of precious stones from, say, 30 to 50 percent and reporting as profit only the difference between the inflated cost and the actual sale price.

False entries on the books of ladies' tailors who double as furriers are used to evade payment of fur excises. This system has the charm of utter simplicity. A fur coat buyer who, of course, pays cash is billed for the amount of her purchase plus tax. This total is entered on the tailor's books as, perhaps, a half dozen different transactions purporting to be labor on excise-free cloth suits and coats for as many different phantom customers.

Typical of the ingenuous evasion methods of some of the small fry is the fisherman who sells a boatload of fish to various dealers and reports only one sale. Or the dress shop which understates or entirely omits cash sales from its records and systematically scales down charge sales. Or the prostitute who sends cash regularly to be deposited in a relative's bank account in another city. Numerous secret bank accounts are commonly kept by tax evaders, often in more than one city.

Tax evasion will be attempted for as long as tax rates offer a sufficient reward to those who are successful. At the present time detection is a hit-or-miss affair. We need to face the fact that the problem of evasion will remain with us for a long time, and we need to develop more satisfactory methods of preventing evasion than now exist.

Failure to keep records not only enables many people to evade taxes but also to avoid criminal prosecution. Where records are nonexistent

or inadequate, the Treasury's only recourse is to prove an increase in the evader's net worth. The Internal Revenue Code gives the Commissioner of Internal Revenue the right to prescribe what records shall be kept by taxpayers. It has been suggested that taxpayers engaged in different classes of business might be required to keep different kinds of records. They might also be required to file periodic statements of net worth.

The law allows the Treasury to reward informers. Tax evaders are continually subject to that risk. Evasion on a large scale nearly always necessitates taking one or more accomplices into one's confidence. In such cases the unpleasant specter of blackmail looms darkly and constantly over the evader's head.

Absolution exists for the evader who makes a misstep and repents in time. It is a rule of the Bureau of Internal Revenue that no prosecution will be recommended against the citizen who, before the Treasury begins an investigation, voluntarily discloses that he has willfully evaded taxes. What amounts to voluntary disclosure may be a technical point, but there is no doubt that many evaders have lightened penalties by revealing their defaults to the Treasury. As a matter of fact, full disclosure never does any taxpayer harm. In any event, during 1946, 115,000 tax evaders turned in more than $170,000,000 on settlements involving no criminal liability.

The Treasury's drive against tax evaders in 1945 and 1946 brought in over $2,000,000,000 of additional taxes and penalties. The success of the Treasury's efforts leads to the inescapable conclusion that tax evasion is a game you can't win. As former Secretary Vinson once tersely pointed out: "There is no future in it."

Chapter 32

THE COMMUNITY PROPERTY SYSTEM

SOME of the principal weaknesses of the individual income tax are not often publicized. In his argument in the Pollock case in 1895 Mr. James C. Carter mentioned the tendency of those who feel the burdens of taxation to relieve themselves of those burdens and pass them to others until in a "one-sided struggle" the "poor always go to the wall." Nothing forbids and much invites high bracket taxpayers to take advantage of many loopholes in the income tax. Attempts to put an end to percentage depletion and the exemption accorded to interest on state and municipal bonds have been consistently unsuccessful, and the Treasury has been unable to persuade Congress to adopt the principle of mandatory joint returns for married couples. These exemptions and the discrimination involved in separate returns, taken in conjunction with the special status of income in the community property states, account for a loss of revenue of more than $1,000,000,000 a year. Of course, other taxpayers must pay the taxes avoided by those who profit by taking advantage of these deficiencies in our revenue system.

Despite our ideal of national tax uniformity, married couples in the nine community property states have a distinct tax advantage over married couples in the other thirty-nine states. The advantage extends to the earnings of both husband and wife and to the income from community property. Under state laws the earnings of husbands and wives in the community property states are automatically divided 50-50 for Federal tax purposes. Residents of these states gain favorable tax treatment under the progressive surtax by this splitting of income, if their combined surtax net income is more than $2,000.

Consider, for example, a married couple with no dependents whose entire income is earned by the husband. On the basis of a net taxable income of $10,000 in a common law state the tax on their family income

would be $2,185; in a community property state the tax would be $1,843. The operation of the community property law reduces their tax liability $342, making it almost 16 percent less than the tax in a common law state. If this couple's income rose to $30,000, residence in a community property state would mean even greater tax saving. In a common law state their tax would be $11,970, as against a tax of $8,541 in a community property state. This difference of over $3,400 amounts to nearly 29 percent of the tax in a common law state. If their income continued to increase, the amount of tax benefit from residence in a community property state would increase until their income reached a very high figure, but the percentage of tax benefit would gradually diminish.

The community property regime flourishes at the present time in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington. Oklahoma, after one futile attempt to ride the same band wagon, has recently enacted a defensible statute. Income from community property in these states is divided between husband and wife without loss of control to the husband and without the legal difficulties and taxes which may be involved in transfers of property between husband and wife in other states.

Although the laws of no two states are exactly alike, generally community property law embraces two classes of ownership: separate property and community property. Separate property includes property owned by the husband or wife at the time of their marriage and the income it yields, plus all property acquired during marriage by gift, devise, bequest or inheritance. All property other than separate property is community property. Community property includes the earnings and acquisitions derived from the economic activities of the husband and wife, and the income and profits from the community property. Community ownership exists only for the duration of a marriage. In case of a divorce the property rights of the husband and wife lose their community character, and each takes his share of the community property. At the husband's death half of the community estate becomes the separate property of the wife. The husband may dispose of the other half by will. In most of the community property states the wife also has a right to dispose of her half by will.

As long as the husband and wife live together the husband has control over the community property. About the only limit to his power over the personal property is that he may not give it away or fraudulently dispose of his wife's rights in it. He may not dispose of the real

property or mortgage it unless his wife gives her written consent. But nothing prevents him from dissipating the proceeds from the sale of real property. In many states the community property is liable for the husband's obligations. It may also be taken by creditors who furnish necessities to the wife, on the ground that the husband is responsible for his wife's support. Whatever it may be elsewhere, in community property states it's still a man's world.

In dealing with the tax effects of community ownership, the courts have been presented with two broad alternatives. They could be guided by state laws which nominally make the wife co-owner of the property or they could recognize the husband's actual economic control. After a period of indecision they chose the former alternative for both income and estate tax purposes. California presents a striking example of the rationalization of the present situation. Prior to July 29, 1927, the California courts generally regarded the wife's interest not as something she definitely owned, but as something she might expect to own. As a result the entire community income was taxable to the husband. But with Federal taxes in mind, the California legislature redefined the wife's interest: her interest was described as "present, existing and equal" to her husband's interest. The change did not noticeably improve the wife's actual economic position. But her mere "expectancy" in community property changed verbally to a "vested interest," and the husband became taxable upon only half of the community income.

A realistic revenue system will scrutinize the essential similarities of the wife's position in the states without community property laws and the community property states. The husband is in command of the property whether it is solely his or is community property. The wife gains no personal possession or enjoyment until the husband's death. Nevertheless, unless a family trust or partnership or some other tax-reducing mechanism intervenes, the income tax strikes at the jugular without mercy in the thirty-nine common law states. Yet it displays tender respect for technical formalities in the nine community property states.

Many abortive attempts have been made to deal with this persistent problem. In 1937 President Roosevelt called attention to the tax inequities of the community property system, and in 1941 and 1942 the Treasury would have by-passed the difficulty in its suggested mandatory joint return provision. Under a system of mandatory joint returns the total tax of a husband and wife living together would be computed

on the basis of a joint return of their income and deductions. Inasmuch as the computation of tax would be based on a single combined income, the actual legal division of income between husband and wife would be immaterial, and every family would be placed on an equal footing as far as husband and wife were concerned. The criticisms aimed at this plan ranged from arguments that the code of family morals would be imperiled to the claim that the hard-gained rights of women would be lost. Congress did not adopt the Treasury's suggestion, and also refused to disturb the favored position of *income* taxpayers in the community property states. It did, however, eliminate the favored *estate* tax status of residents of these states. The constitutionality of this provision has recently been sustained.[1] The latest method suggested for solving the difficulty is to split family income equally between husband and wife in all states, as is done in the community property states. This per capita approach would equalize the tax treatment of married couples as effectively as mandatory joint returns.

We may hope that Congress will soon resolve this inequity in the income tax field, for a majority of the Supreme Court recently failed—in the language of Mr. Justice Douglas who dissented—"to face the issue squarely." No one has the slightest desire to interfere with the prerogative of the community property states to adopt whatever system of property rights they please. But taxes should be uniform in their application throughout the nation, particularly when rates are high and progression steep. Otherwise resentments will impair the effectiveness of our tax system, which depends, more than is commonly supposed, upon the co-operation of taxpayers.

In dealing with the community property problem we should not forget that our tax laws also permit serious discriminations in the treatment of family income in noncommunity property states. In these states taxes can be saved by the device of splitting income. For example, a husband whose income is derived from capital may reduce his tax by making an outright gift of part of his property to his wife, or by using the device of joint ownership or by creating a trust. A person with earned income cannot reduce his tax by these devices. The issue of uniformity raised by these practices should be faced just as squarely as the community property problem.

[1] Fernandez *v.* Wiener, 326 U. S. 340 (1945).

Chapter 33

TRUSTS

ALMOST from the beginning of the income tax, trusts have been a sea of troubles. They have cut down the usefulness of the estate tax as well, and they have been a baleful influence in gift tax territory. After more than a quarter of a century of conflict, confusion has become completely confounded. A wholesale reorientation of the subject is vital to our future tax system.

Trusts are an old institution in the law, and their complexity has grown with their age. They consist of a transfer of property to a trustee—who may be an individual or a corporation, or both, or even the person who makes the transfer—with instructions as to the disposition of the income and principal of the property. The income may go to one person for life and the principal to someone else. This simple pattern may be varied in many ways. The trust may end after a specified number of years or upon certain contingencies, such as the death of some named persons. The essential accomplishment of the trust is that it extends the effect of a transfer of property into the future according to the events of the future. An outright transfer gives property to a definite person who receives all rights to deal with the property as his own and may in turn transfer it to someone else. A trust splits the property into parts and gives each part to a specific person, or to a person who will be entitled to receive a part at a specified date and upon certain conditions. At other dates and upon other conditions the property may go to someone else. Thus a trust attains a flexibility that is not possible in an outright transfer of property. Moreover, a trust frequently makes it possible to give and not to give, that is, to give and yet keep many of the essential attributes of ownership. One of these attributes is the power to decide which of several persons shall enjoy the property; another is the control of a corporation whose stock is placed in trust.

It is supposed to be the general income tax rule that trusts are treated as individual taxpayers, unless they are trusts of the type which are doing business in the manner of corporations—such as Massachusetts trusts. If the trust income is accumulated, the trustee pays the tax upon the income. However, if the income is currently payable to the beneficiary, the beneficiary pays the tax. This system has raised innumerable questions as to whether the trust or the beneficiary should pay the tax on trust income.

The "annuity" trust has been one of the principal points of controversy in this area. Until a few years ago a husband might put securities into a trust for his wife and provide that a definite sum of, say, $10,000 a year be paid to her; payments were to be made out of capital if the trust income were insufficient. This provision for payment out of principal would make the income taxable to the trust regardless of whether there *were* enough income and even if payment were in fact made out of income. Thus, without affecting the family economic situation, a taxpayer could secure a lower family income tax by mere words in a trust instrument which had the effect of diverting income from his own high tax brackets to a trust which began to compute its tax at the low end of the income scale. The Revenue Act of 1942 closed this loophole by making the facts control; taxability is now dependent upon whether there is income in the trust. If there is, distributions from the trust are taxed to the extent of that income to the person who receives the distribution, and not to the trust itself.

A cruder device of the thirties was multiple trusts. The general purpose of this device was to split the income of the family unit among a number of trusts, and thus secure both lower surtax rates and additional personal exemptions. The idea was applied both to capital gains and ordinary income, and was sometimes carried to extraordinary lengths. One taxpayer, on the eve of a capital gain of nearly $4,000,000, created sixty-four trusts—nineteen for his wife, fourteen for his son, seventeen for one daughter and fourteen for another daughter. This loophole has been only partially closed by reducing the trust exemption to $100.

Hard as these problems appeared at the time they were most controversial, they now seem like child's play compared with another question which is raised by many trusts: Should the income of a trust be taxed on the one hand to the trust or its beneficiaries, or on the other hand to the person who sets up the trust? In the latter instance the

tax is likely to be much higher because the person who sets up the trust will usually have other income also. The fundamental question is whether in *tax* law, as distinguished from *trust* law, there is any trust at all. Or has the person establishing the trust merely resorted to a formal device which strips him of some aspects of ownership of the property he puts in the trust, but leaves him with so many rights and powers that he is justly taxable on the income of the trust?

The best imagination of the tax bar has been devoted for many years to creating trusts which, without changing economic position any more than is vital to the tax-saving objective, will split the former owner's income into separate parts which may each begin to compute the tax at the lowest rates. An enormous tax saving may be accomplished if the taxpayer is successful. He can, and should, be successful if there is absolute transfer of ownership, for he has the right to make gifts even though he may be taxed for exercising that right. Taxpayers are reluctant, however, to make transfers any more complete than is necessary. They like to hold on to as many strings as they safely can. The line of safety is constantly shifting, which means that litigation on this subject swamps the courts.

The earliest type of tax-avoiding trust was a plain revocable trust, that is, a trust which might be ended at the pleasure of the person who established it. For a time this type of trust was recognized as transferring the tax away from the person who established it. But such an easy avenue of avoidance must soon reach a dead end. A revocable trust had no tax reality. In 1924 Congress inserted provisions in the tax law to disregard trusts which did not sufficiently transfer ownership away from the persons who established them. But taxpayers, with considerable help from the courts, learned many ways of circumventing these provisions. Then the Supreme Court had to come to the rescue of the revenue. In Helvering *v.* Clifford,[1] an outstanding decision, it held that a husband must pay the tax upon the income of a five-year trust in favor of his wife. The decision turned on the short term of the trust, the fact that it was a "family" trust and the fact that the husband as trustee retained full investment powers. The court thought that in these circumstances the husband remained in substance the owner of the trust property.

Lawyers have quarreled about this decision ever since Mr. Justice

[1] 309 U. S. 331 (1940).

Douglas' opinion startled the tax world in 1940. Mr. Justice Roberts wrote a dissenting opinion at the time and Mr. Justice McReynolds agreed. The dissenters thought the Supreme Court was usurping a Congressional prerogative; the courts ought not to plug loopholes. But the difficulty with the decision was not that it was judicial legislation, but rather that it enunciated a broad principle that the income tax could not be avoided by the use of family trusts which did not change economic position, but merely reallocated income within the family unit. This principle is hard to apply in concrete cases. Trusts are infinitely variable. If these questions reach the courts they must decide whether each particular variation puts a trust in one category or another. Time has vindicated the Clifford decision. But there are types of questions which should not be left to piecemeal judicial treatment. They should be courageously handled by the Treasury, which has the experience to draw up a more detailed pattern than the courts can easily apply case by case to a large area of varying situations. A regulation outlining some subordinate rules of application of the Clifford principle was finally issued in December 1945. In January 1947 an amendment was proposed which made this regulation even more favorable to taxpayers than it originally was. Any substantial retreat from the stand taken in the amended regulation, as has been advocated in some quarters, would make tax avoidance plain sailing and seriously endanger the revenue.

Chapter 34

FAMILY PARTNERSHIPS

A RECENT heavy crop of court cases indicates a new spurt of activity in another well-established type of family generosity. This particular variety of liberality is practiced by husbands who make their wives, and sometimes their children, partners in their enterprises. The arrangement frequently has nothing to do with business; the purpose is merely to reduce taxes by dividing the business income among two or more persons.

There is a cardinal rule of tax law that income is taxable to the person who earns it. By merely assigning income to his wife, a husband cannot shift the tax to his wife. He remains taxable even though he turns the income over to his wife before he actually receives it. However, the story is different if the income is produced by capital and the husband divests himself of substantial dominion and control as sole owner of the capital. Then the wife becomes liable for tax upon the income, despite the fact that the income, in the words of Mr. Justice Holmes, "in every probability" will make the husband's life "easier and help to pay his bills." In terms of these fundamental principles, two questions arise in family partnership cases. One relates to the earned income of the partnership. There the issue is whether the income is earned essentially through the husband's personal services. The other question relates to income produced largely by capital; that question is whether the wife exercises substantial management and control over the capital invested in the business.

The requisites of a partnership, as stated in many court opinions, are "that the parties must have joined together to carry on a trade or adventure for their common benefit, each contributing property or services, and having a community of interest in the profits." The contribution of "property or services" is therefore vital to membership in a partner-

ship. Clearly a wife may be a partner with her husband in a business wholly, or largely, dependent upon personal services only if she actually renders services. If she renders no services to the business, her husband has done no more than assign his income to her; he retains control of the income because it can be earned only through his continued efforts. She is not a partner in any real sense of the term.

When the partnership is engaged in an undertaking in which capital is an important, if not the principal, income-producing factor—such as a mercantile or manufacturing business—the wife need not contribute her services in order to become a partner. Since the firm's income is dependent upon capital as well as services, the wife, as a partner, may furnish capital needed in the business. Contributing capital is also one of a partner's functions.

But in mercantile and manufacturing businesses the wife's contribution of capital may be open to question. If she claims that she has contributed money, where did she get the money? If she has made a contribution out of her independent means, there is no problem. But suppose, for example, that her contribution is represented by a note to her husband and it is understood that the note is to be paid out of her share of the profits. Suppose that her contribution was an undisguised gift from her husband. Or suppose that she contributed property she received upon the liquidation of a corporation and that her husband had given her stock in the corporation with the understanding that the property she received when the corporation was liquidated would be put into the partnership. The Supreme Court has recently indicated that in these instances the wife has made no true capital contribution, and that the partnership has no tax standing unless the wife shares in the management and control of the business or otherwise contributes vital services.

The question of management and control spreads into a number of subsidiary inquiries. Does the wife have any voice in the partnership business? What do the entries on the partnership books reveal? Are capital accounts, which would reflect a capital contribution by the wife, put upon the books? Does the wife have a drawing account? May she draw checks against the partnership account? How are they charged? What is done with her withdrawals? If they are used for household expenses, it seems fair to infer that there is nothing more than a temporary reallocation of income within the family group.

And, considering the marital relationship, the wife's right to withdraw profits may be more fanciful than real.

As to both husband-wife and parent-children partnerships, the perennial questions will be asked: Is it not true that taxpayers have a right to avoid taxes by every legal means at their command? Are they not free to arrange their affairs in any way that will reduce their tax burden to a minimum? The answer is yes. A tax-avoiding motive in the formation of a partnership is of itself insufficient to preclude using the partnership to divide income among the partners. But motive furnishes a clue to the understanding of vague partnership agreements and ambiguous conduct of partnership affairs, and the courts may view partnership activities in the light of the interest and purpose of the partners, especially when they are members of the same family.

No reasonable person would doubt that a husband and wife may create a partnership that must be recognized in tax law. On the other hand, no fair person will blame the Treasury for vigilance in this field of tax avoidance. The problem is to distinguish between partnerships that should be respected and those which should be disregarded, whatever their status may be under local law. The family partnership problem cannot be successfully treated as a local disease. Family trusts, family partnerships and family corporations are in one sense all the same thing. They all may seek to reduce taxes by splitting, postponing or otherwise controlling the receipt of taxable income without a substantial surrender of economic dominion by the person who would otherwise have to pay tax. They may not change economic status, but merely present different façades. Substantial ownership of business, the routine of daily life, may go on as before. Lawyers who put aside their special interest as advocates, and their inherent fondness for legal subtleties, know that this is so. Taxation will not be the practical matter it is so often said to be until it develops a ruthless capacity to disregard the empty legalisms and the economic pretenses of the family partnership, the family trust, and even the family corporation, in favor of the facts of family life.

The Treasury should try to develop the subject of family partnerships by regulation, as it has the subject of family trusts. Such an attempt would square with a growing recognition of its responsibility to exert its rule-making power, for inaction would pass the problem to the courts or Congress. The courts are hardly adapted to provide a prompt

or satisfactory answer. Nor is legislation of the usual character adapted to such a problem. On the basis of existing law a sound answer can be furnished only by a courageous exercise on the part of the Treasury of its rule-making power. Any regulation on the subject should be sufficiently imaginative and sufficiently generous to command the respect of the courts and Congress. In ultimate analysis legislation may be necessary; family returns, or a splitting of income among members of all families, may be the only solutions.

Chapter 35

TAX-EXEMPT BONDS

CHIEF JUSTICE STONE once said that it is "in the public interest that no one should be permitted to avoid his just share of the tax burden except by positive command of law." The Internal Revenue Code has such a positive command in a provision which exempts from tax "interest upon the obligations of a state, territory, or any political subdivision thereof."

A fair tax system will reverse this command and exact from the holders of these bonds a contribution to the cost of the government which protects their lives and property. In 1942 the contribution they failed to make was estimated to exceed $200,000,000 a year.

Now that the war is over, this loss may be somewhat less. Tax rates, the speed with which capital outlays are increased, the state of business—all will influence the size of the future loss. Then, too, interest rates have declined. "Tax-exempts," as they are called, now bear an *average* coupon rate of 3⅗ percent; the interest rate in recent years has in general been below 2 percent. But this loophole, by which wealth finds a hiding place and which makes a mockery of the principle of taxation according to ability to pay, will remain wide open unless Congress takes steps to close it.

At the present time tax-exempts are thought to be concentrated largely in the hands of high bracket taxpayers who benefit most from the exemption. Tax-exempt institutions and insurance companies have liquidated a large proportion of their tax-exempt portfolios in the last few years, but there is still a considerable reservoir of these securities which may be purchased by taxpayers who seek this safe haven from high taxes.

There is little defense for a statutory provision which in a recent year permitted Mr. X to escape all Federal tax on $668,700 out of an

annual income of $974,600, thus avoiding a tax of about $600,000. Mr. X was doing only what the statute permits, but his example does not help to make other taxpayers willing to do their part, particularly since most of them have only earned income and cannot resort to Mr. X's method of avoidance.

If the holders of tax-exempts had paid for their exemption privilege, they might have a case for its continuance. But they have not. Of about $20,000,000,000 of those bonds, recently outstanding, about $10,000,000,000 had been outstanding for more than ten years, according to estimates made in 1941. Insofar as market prices reflected the exemption privilege, they did not reflect exemption from present levels of taxation. A person with income from other sources of $100,000, who purchased a 4-percent tax-exempt security in 1929, obtained the equivalent of a return of about 5¼ percent under 1929 rates. Under wartime rates he derived as much benefit from his 4-percent bond as he would from a taxable security yielding 40 percent. Under existing rates the benefit is hardly less substantial.

Aside from its inequity and cost to the Treasury, the tax exemption accorded to state and local securities also tends to discourage risk-taking. The tax advantage of riskless investment and the relative disadvantage of risk investment are greater the higher the surtax bracket. Consequently, the tax exemption deters risk investment most at the source from which venture capital is expected to flow. Any tax program designed to encourage investment should necessarily close this loophole.

The defenders of this special privilege sometimes resort to arguments based upon state and local sovereignty. The income from state and municipal bonds is assumed by many to be exempt from Federal taxation. And the same assumption is made about the inability of the states to tax the income from Federal securities. This concept of mutual exemption stemmed from a decision of the Supreme Court in McCulloch *v.* Maryland[1] in 1819. Declaring that the "power to tax involves the power to destroy," Chief Justice Marshall ruled that if the states could exercise their taxing powers upon functions of the Federal Government, and vice versa, each could in effect nullify the sovereignty of the other. But a justice of the Supreme Court of more than a century later revised the Marshall aphorism. In 1928 Mr. Justice Holmes, de-

[1] 4 Wheaton, 316, 431 (1819).

livering a majority opinion, declared: "The power to tax is not the power to destroy while this Court sits."[1] In a more recent opinion Mr. Justice Frankfurter took occasion to point out that Chief Justice Marshall spoke at a time "when social complexities did not so clearly reveal as now the practical limitations of a rhetorical absolute."[2]

Elimination of the exemption—which is now embedded in the statute—would give no new powers to the Federal Government. It would not give the Federal Government the right to tax state and local interest at rates higher than would apply to other forms of income. It would give to the Federal Government the right to do what thirty-three states imposing personal income taxes already do themselves—tax the interest on obligations of other states and their subdivisions.

The first and last refuge of the defenders of the tax-exempt discrimination is the Constitution. But they are thinking of the Constitution of another day. On April 14, 1942, Assistant Attorney General Clark gave his unequivocal opinion in favor of the constitutionality of taxing income from outstanding, as well as future-issued, state bonds. His persuasive opinion is published. Recent decisions of the Supreme Court give every indication that this opinion would be sustained.

[1] Panhandle Oil Company *v.* Knox, 277 U. S. 218, 223 (1928).
[2] New York *v.* United States, 326 U. S. 572, 576 (1946).

Chapter 36

PERCENTAGE DEPLETION

FEW groups of taxpayers are so favored as those who can take depletion deductions on oil, gas and mineral properties. These deductions frequently turn out to be sheer gifts from the United States to individual taxpayers and corporations and their stockholders. For almost thirty years Congress has permitted a special "percentage" depletion allowance to the owners of these properties; for ten years the Treasury consistently, but unsuccessfully, tried to abolish it.

In 1933 the Treasury recommended the elimination of percentage depletion on mines and oil wells on the ground that it was a "subsidy" to a special class of taxpayers. President Roosevelt and the Treasury followed with a similar recommendation in 1937. In 1942 Secretary Morgenthau cited percentage depletion as an "example of special privilege." Before the House Ways and Means Committee and the Senate Finance Committee he and I presented a detailed case both for striking out the statutory provision allowing percentage depletion and for eliminating an option given by the regulations to deduct capital expenditures for so-called "intangible" drilling expenses, which consist mostly of the labor cost of drilling wells. The Treasury estimated that the annual loss of revenue involved $200,000,000. But both committees voted to retain the provision allowing percentage depletion and not to disturb the practice of permitting the deduction of intangible drilling expenses. The ill-fated attempts to plug up this loophole were not renewed in 1943.

In 1944 one of the curiosities of the Republican platform was a plank in favor of the "continuance, for tax purposes, of adequate depletion allowances on oil, gas and minerals." The platform made no other specific tax recommendation. It gave aid and comfort to no other beneficiaries of statutory loopholes. Why, then, did a major political party single out depletion for attention?

Uneasy recollections may have haunted the minds of the victors in the 1942 controversy over the provision. For the Republican depletion plank was an obvious attempt to commit the party to the joint stand of Republicans and Democrats in 1942. There could be no other reason for selecting this item from thousands that could be mentioned in the tax field. The platform suggested no constructive changes. It simply said: Let's stand pat on depletion.

If depletion deserves mention in a major party platform, it deserves understanding by the voters. The subject is technical, but the principles involved are simple. Depletion of mineral resources is one of the statutory deductions allowed in determining the taxable net income of the owners of mines and oil and gas wells for a given year.

The original theory was that mineral properties were exhausted in the process of producing financial return, and that part of every dollar received was not taxable because it was not profit, but only a return of capital invested. World War I carried this theory to new outposts. The geologic experts of the day bemoaned our scant supply of oil which, they predicted, would hardly last ten years. The incentive tax experts of 1918 took up the chorus. They proposed that something should be done to stimulate production and protect the prospector or wildcatter who risked drilling in unknown territory.

Congress responded in 1919 with a provision for "extraordinary" treatment of taxpayers discovering oil and mineral properties, giving them the right to base their depletion not on original cost, as previously, but on the fair market value of the property at the time of discovery. The extraordinary became ordinary, and this provision remained in the statute with some modifications for many years, notwithstanding the fact that our oil reserves appeared to be increasing rather than diminishing.

The 1918 Act extended a benefit to the owners of mines and oil and gas wells which other property owners did not have. Insofar as oil was concerned this provision had a good deal of sense to it in the light of its premise—scarcity of oil. It may have been a desirable subsidy at the time, but the provision required the valuation of every discovered well and every newly discovered mine in the United States, which turned out to be a great administrative burden. When the administrative job was largely done, the labor it involved was used as an excuse for changing the statute. Beginning in 1925 depletion of oil and gas wells was

to be computed on a percentage basis. Whether he made a discovery or not, the owner of an oil or gas well was to be allowed to deduct 27½ percent of the gross, or 50 percent of the net, income from his property, whichever was less. In 1932 similar treatment in varying percentages was accorded to the owners of iron, coal, sulphur and metal mines. This last privilege was extended in 1942 to fluor spar, rock asphalt and ball and sagger clay, and in 1943 to vermiculite, potash, feldspar, mica, talc, lepidolite, barite and spodumene without a showing, at least in some cases, that current output was inadequate for war needs.

The tax law's solicitude for oil and gas producers does not stop when the property has paid for itself, as with depreciation allowances on plants and machines, but goes on as long as production continues. On the average the allowance for oil has consistently run about six times the actual depletion sustained on actual cost. Comparable treatment of taxpayers engaged in manufacturing activities would permit charging the cost of part of physical plant to expense and the continued deduction of depreciation until the amounts charged off aggregated six times the original cost of the plant.

In presenting its case for eliminating percentage depletion, the Treasury showed in 1942 that oil reserves, thought to be nearly exhausted in 1918, were at an all-time high of over 20,000,000,000 barrels in 1941. As a matter of fact, daily production rose from 3,750,000 barrels on July 1, 1942, to 4,580,000 barrels on July 1, 1944. The Treasury showed that one company in a Texas field had secured depletion of $3,600,000 on properties only about 25 percent exhausted which originally had cost about $3,000,000; it had recovered more than 100 percent of its cost with 75 percent of its oil left in the ground. The Treasury also showed that it would have cost the government about one-third as much to have paid the entire cost of all wildcat dry holes in 1941 as to have allowed percentage depletion to all wells, including wells in proven areas. Finally, the Treasury suggested an alternative depletion provision which would have permitted percentage depletion to stripper wells, marginal mines and also to discoveries of new pools and newly discovered mines.

Fear of interference with the war effort was a large factor in dissuading Congress from accepting the Treasury's 1942 recommendations. That fear need no longer haunt us, and the problem of eliminating a discriminatory subsidy in favor of an established industry must be faced

sometime in the future. Whatever may be the situation regarding some minerals, it may be faced without fear of an oil shortage; indeed, if there is danger of a shortage in the future, the wise policy may be to conserve the oil we have rather than to encourage production. Subsidies are sometimes justifiable; at other times they are perilous ventures. They may be warranted where they reward particular units in an industry for special risks taken, especially if the financial position of those units would otherwise preclude taking great risk. But they are inexcusable where they serve no public purpose and indiscriminately favor entire industries which are in an established financial position far beyond need of special government help. For then their effect is to shift part of the tax burden to the shoulders of others who are less able to bear that burden. A sound tax system will permit no one segment of business to ride roughshod over others. It will treat alike all who are similarly situated.

Chapter 37

ESTATE AND GIFT TAXES

1. *Defects of Existing Taxes*

PLINY the Younger argued that a tax upon inheritanc was "an 'unnatural' tax, augmenting the sorrow and grief of th bereaved." But Pliny was in the minority even among the ancients, an his protest has been disregarded through the centuries. Certainly Congress has paid only spasmodic attention to it. After a period o tribulation in the twenties both the Federal estate tax, enacted in 1916 and the Federal gift tax, enacted in 1924 and temporarily repealed in 1926, gained a permanent foothold in the American tax system. They are not very likely to be dislodged by the acceptance of such a recom mendation as that made in 1945 by the Committee on Postwar Ta: Policy which would assign exclusive jurisdiction of estate and gift taxe to the states, on the grounds that the states have "pressing need for al available revenue sources," and it "would probably insure that, in th near future at least, the revenue motive, rather than the social motive would be predominant."

The importance of the estate and gift taxes is out of all proportio to the number of people they affect and their revenue yield. Thes taxes have the important economic objective of preventing undue con centration of wealth. Moreover, while only about 1 percent of thos who die in adult age leave estates which are taxable under presen Federal law, and while very few people possess enough of this world' goods to have gift tax problems, this small minority of our populatio is affected at a very sensitive point. Obviously, where their treasure is there are their hearts also.

Why people care so deeply about the estate tax and so sedulously tr to avoid it would provide an interesting study in psychiatry. Unlik the income tax, the estate tax is not paid out of the pocket of a livin

person; nor is it sufficiently severe in effective rate and coverage to prevent adequate provision for dependents. Those who will one day pass on substantial wealth ache vicariously for others who, experience often shows, are not grateful for, or even careful with, what they receive. And yet there is no lack of thought about how to circumvent the estate tax, and propaganda to that end—euphemistically called "Estate Tax Planning"—invariably has a large audience. In fact, no one can study the story of tax avoidance in relation to the Federal estate tax, as well as the gift tax and the income tax, without developing profound misgivings as to the future, not only of our tax system, but of our civilization.

Yet when we pass from the principle of estate and gift taxation to the particular Federal estate and gift taxes now in force, we must admit that the fault is not altogether with taxpayers. In their present form, these taxes are not as equitable or predictable as they should be. Nor do they sufficiently protect the revenue. They put a premium on tax avoidance through the transfer of property by gift during life—sometimes by the use of trusts which accomplish less than complete transfers of ownership—rather than by bequest. At the same time their relationship with each other and with the income tax is completely out of focus, making in several instances for duplication of incidence or overlapping. Too often the best legal talent cannot foresee their impact. Legitimate planning is therefore difficult at times. While certainty may not be as important in the estate tax field as it is in taxes affecting commercial transactions, every citizen is entitled to know, as far as is reasonably possible, the burden which his estate will have to bear at the time of his death.

A glaring weakness of existing estate and gift taxes is the separate treatment of transfers of property during life and at death. The gift tax was enacted as a dual protective device; it attempted, with the usual lack of success attendant upon such ambition, to kill two birds with one stone. It was intended to protect the estate tax from avoidance through transfers of property between living persons and to protect the income tax from the raids of high bracket taxpayers who minimized this tax by making gifts within the family. In the light of these intentions the gift tax has been conspicuously unsuccessful. The worst part of the failure of both the estate and gift taxes is their tendency to hit hardest those who least deserve to be taxed. The astute avoid and escape tax; the

unwary and ingenuous are lost in a dusk of uncertainties which darkens as Congress adds amendments to the statute, and the Treasury and courts plod through their weary task of interpretation.

Although the gift tax is considered an adjunct of both the estate and income taxes, its rate structure is so devised as to invite transfers to circumvent both of these taxes. Gift tax rates are traditionally kept at 75 percent of comparable estate tax rates. Estate tax rates now start at 3 percent on the first $5,000 of the net estate and reach a top of 77 percent on that portion of the net estate exceeding $10,000,000. Gift tax rates range from 2¼ percent to 57¾ percent. But tax savings from transferring property during life are much greater than this 75-percent ratio would indicate. A person who transfers property during life enjoys the benefit of two separate exemptions—$30,000 under the gift tax, which he may exhaust over the years as he sees fit, plus $60,000 under the estate tax. In addition, he is entitled to an annual exclusion of $3,000 for each of any number of persons to whom he makes gifts, so that during his lifetime a considerable sum may be transferred without tax. Property transferred during life often escapes estate tax when the donor dies. Of course those who die suddenly or at a youthful age are at a distinct disadvantage under this system. They may not live long enough to reap income tax savings on their gift tax investment and the opportunity to pile up $3,000 annual exclusions may be lost. Moreover, property which would be subject to the highest estate tax rates, if held until death, falls into lower gift tax brackets when given away during life, thus aggravating the disparity in rates between transfers during life and transfers at death. Furthermore, the amount paid out as estate tax is part of the base upon which the tax is computed, but the base of the gift tax does not include the fund which is finally paid out as gift tax.

The saving of estate tax by transferring property during life may be clearly seen in the following example:

Mr. Brown and Mr. Smith, two prosperous individuals, each have $3,000,000. Mr. Brown clings to his entire fortune until death. The tax on his estate is $1,231,000, which leaves $1,769,000 for his wife and children. Mr. Smith avails his wife and children of the saving which the tax law permits. He makes them a gift of $1,000,000 and pays gift tax on that amount. The gift tax, which he paid during life, plus the tax on his $2,000,000 estate, paid at his death, amount to $856,000, which

leaves to his family $2,144,000. In this instance, $375,000, or more than 10 percent of the original $3,000,000, is saved in estate tax by making a gift.

The relationship between estate and gift taxes, which places a premium on transfers during life, is further highlighted by the relationship between the gift and income taxes. To circumvent the income tax, while keeping the income within the family, many people make gifts to close relatives who have little or no other income. A part of the donor's income is thus shifted from high to lower tax brackets. While the gift tax is supposed to intervene at this point to discourage income tax avoidance, it rarely compensates for the loss of income tax revenue. Moreover, the highest income tax rates may be avoided by transfers which are subject to only the lowest gift tax rates. As things now stand, the gift tax fails completely to make up for the loss of income tax on the income from property covered by the $30,000 exemption and the $3,000 annual exclusion.

Even as trusts are used to avoid the income tax, they are also widely used to put property beyond the reach of the estate tax. Mr. Smith, in the previous example, could have accomplished the same tax saving without making an outright gift. Moreover, if he passed property on his death to Mrs. Smith and, after five years, she passed the property on her death to their children, John and Mary, and if John and Mary on their deaths passed the property to their children after five years, there would be four estate taxes on the property. The trust device can save all but one of these taxes, and accomplish other objectives as well. For a comparatively small fee Mr. Smith's lawyer could draw a trust which would put the title to his property in the name of a trustee. Under instructions contained in the trust, the trustee would pay the income from the property to Mrs. Smith for her life, then to John and Mary for their lives, and after John and Mary's death he would pay the principal to their children. There would then be a tax on the property only when Mr. Smith died; there would be no tax at the time of the subsequent deaths. Or if Mr. Smith's attorney were wise, the trust might give the right to John and Mary to choose which children should receive the principal and in what proportions. In this way a power would be placed in John and Mary to dispose of the property within the family substantially as if they were outright owners, but no tax would be imposed upon their exercise of the power.

Still another shortcoming of the estate and gift taxes is hoary with age. The estate tax provides for taxing transfers of property made before death, but in contemplation of death. Prior to 1926 a supplementary provision stated that substantial gifts made within two years of death would be presumed to be in contemplation of death unless the taxpayer established otherwise. In 1926 Congress stipulated that transfers within two years of death were conclusively presumed to be in contemplation of death. But in 1932 the Supreme Court held[1] that this provision was unconstitutional. Congress then returned to the presumption in effect prior to 1926, permitting the offer of proof that the deceased person did not contemplate death when he transferred his property. Motive, therefore, is the touchstone. But proof of the motive must be circumstantial, since the maker of the gift is unavailable to testify. It is hardly surprising that evidence refuting contemplation of death has become a mass of trivia. Any provision which gears tax liability, as this provision does, to such ephemeral considerations as a dead person's onetime cheerful spirits, pleasure in seeing others enjoy property, desire to spend some time in California, resumption of the habit of knitting, medicinal taking of whisky, making a long apartment lease, Sunday game of golf or purchase of a fur coat, is truly more productive of litigation than of revenue.

Lack of correlation among the estate, gift and income taxes is another major defect of the present structure of these taxes. Each attaches certain consequences to transfers of property, but there is no correlated or uniform definition of a transfer under the three taxes. A gift during life may be treated as a completed transfer under one tax, and simultaneously considered incomplete under another.

For example, Mr. Smith may put property in a trust and retain the right to revoke the trust with the consent of the beneficiary receiving the income of the trust, whose rights would therefore be adversely affected by returning the property to Mr. Smith. The tax on the income of this trust will be shifted to the beneficiary, but the principal of the trust will be taxable as a part of Mr. Smith's estate. Or Mr. Smith may put property in a trust and place the right to revoke the trust wholly in another person who has no interest in the trust. The income of the trust will remain taxable to Mr. Smith; however, the principal of the trust will no longer be taxable in Mr. Smith's estate. Or Mr. Smith

[1] Heiner *v.* Donnan, 285 U. S. 312 (1932).

may put property in a family trust for a period of years. He is required to pay gift tax when he establishes this trust, even though the income from the property in the trust may remain taxable to him as if he had not really made a gift at all.

2. *The Possible Remedies*

Obviously, a more integrated system of estate and gift taxes is sorely needed. One palliative, frequently advocated for the present unwholesome state of affairs, is what Dean Erwin N. Griswold of the Harvard Law School criticizes as "tinkering" with the present system. This remedy would attempt to eliminate discrepancies by piecemeal changes. But it is unlikely that changes of this nature would ever produce the essential framework we need; more likely they would merely aggravate an already bad situation. The tax system would still be left in a hit-or-miss condition, and the correlation process would continue indefinitely. Since the present haphazard situation is largely the result of piecing here and patching there, continued applications of the same treatment would hardly assure better results.

Another recommendation, also frequently advanced, has been elaborated in some detail by Dean Griswold. It looks toward a comprehensive correlation of the income, estate and gift taxes to remove discrepancies. Transferred property attributed for income tax purposes to the person who transfers it would be similarly treated for estate tax purposes, and the gift tax would apply where the income and estate taxes left off. Correlation would operate on the "string" principle. As long as the person who transferred the property kept one of various specified strings tied to it, such as the power to dispose of it or a wide variety of powers of control over the property, he would be liable for income tax and the property would be included in his gross estate at death. The gift tax would appear on the scene only when all strings were severed.

Undoubtedly, a thoroughgoing revision along these lines would dispel the dissatisfaction provoked by the overlapping and disparities in tax burden that now occur. What constituted a taxable transfer would become clear. But correlation does not solve the problem of a dual system of transfers with different rates and double exemptions. It would not close the gap in tax liability extending over several genera-

tions, nor would it solve the contemplation of death problem. In fact, it would not accomplish very much in terms of existing defects. It is, perhaps, a desirable objective, but its attractive features should not be allowed to obscure its shortcomings.

I believe that many serious defects in our existing estate, gift and income tax structure could be rectified, first, by integrating the estate and gift taxes into a single transfer tax and, second, by correlating this integrated transfer tax with the income tax so that the transferor's income tax liability would cease once the transfer tax was imposed. A transferor would then be obliged to pay income tax on the income of property until he had paid a tax on the transfer of the property to another person, but his obligation to pay income tax would at least end when he made a taxable transfer.

With this type of integration the transfer at death would be the final disposition. A single exemption could be provided, part of which might be used against transfers between the living. For example, if the exemption were the sum of the present estate and gift tax exemptions, during his life the transferor would be entitled to an exemption of $30,000, which he could exhaust over the years as he saw fit. At his death his estate would be entitled to an exemption of $60,000 plus any unused balance of the $30,000 allowed on transfers between the living. If he had used none of the exemption during life, his estate would be entitled to a total exemption of $90,000. Everyone would be entitled to the same total exemption, regardless of whether any portion were applied against transfers during life. Now any unused portion of gift tax exemption simply disappears when the transferor dies. Under this plan a single table of rates would apply to all transfers. Generally speaking, it would be relatively unimportant, except for income tax purposes, whether transfers were made during life or at death. But the tendency to manipulate transfers in order to obtain the maximum benefits as a result of separate levies would be appreciably curtailed. And the legal problem of contemplation of death would automatically disappear.

Integration would go a long way toward improving the present estate and gift tax structure. It would not, however, solve the problem of tax avoidance by means of trusts. There is a widely held impression that the estate tax is unable to fasten upon property which passes from one trust beneficiary to another—say, from Mrs. Smith to John and Mary in the example previously given—since the deceased person, Mrs.

Smith, has never been the full-fledged owner of the property. But the British estate tax, which has been in existence since 1894—the same year our "unconstitutional" income tax was passed by Congress—has long had special provisions dealing with property placed in trust. Under our present Federal estate tax, property which is transferred outright bears a far heavier tax load than property which is left in trust. Can such an inequity be resolved? There are four possible approaches to this phase of the problem.

One course is to impose an additional tax upon the first disposition in trust—the one from Mr. Smith to Mrs. Smith—to compensate for the interim loss of revenue as a result of the use of the trust rather than several outright transfers. There are three difficulties with this approach. First, the compensatory levy might have to be so high that it would be politically infeasible. Second, the additional tax would fail to differentiate between one shift and several shifts in interest in the property left in trust. Finally, a levy upon the first disposition in trust would enable all successions under trusts now in existence to escape tax.

Existing English law offers a second approach, namely, to tax the property when the beneficial enjoyment shifts from one person to another. Upon the death of the life tenant, that is, the person receiving income for life—Mrs. Smith and John and Mary in the above example—the property would be included in his estate. Thus the life tenant, who has never owned the property, is given a full owner's status at death. In the United States such a tax might raise some constitutional doubts, though they may not be as serious as many people suppose. However, regardless of the particular type of transfer, the British estate tax offers a solution to this country's problem of insuring that the estate tax takes the same periodic bite out of property as it moves by the trust device from one generation to another.

A third alternative would approach the problem from the taker's side of the transfer by imposing a supplementary *accessions* tax upon the person who receives the property. The tax upon each person receiving the property would be based upon the value of what he received—life estates in the case of John and Mary and the full property in the case of their children. This method of taxation would reduce the existing discrimination against outright dispositions of property, but would introduce valuation difficulties where complicated interests were transmitted.

The fourth possibility is the imposition of a supplementary estate tax upon property passing in trust. As an *estate* tax, the levy would avoid many of the valuation complexities of an accessions tax, since the tax would be laid upon the *transfer* of beneficial enjoyment and not upon the *receipt* of the property. The tax would differ from the British death duty in that the trust property would not be added to any other estate which the deceased person might have. A tax of this type would be quite in line with our present system and its established concepts.

For the future a number of other problems in the estate tax field must be resolved. The statute now has a twin rate structure with different exemptions applying to two taxes, one imposed by the 1926 Act and the other by later acts. There is no excuse for this kind of complexity; one rate structure is enough. Exemptions should be lowered and should, perhaps, be differentiated according to the relationship of the person who receives property to the person who dies. A wife or husband might be considered a favored recipient. And, finally, rates should be substantially increased. There is nothing sacred about the right to transmit property. Inheritance is not one of the inalienable rights of man, but only a creature of the law of the moment. There should be a greater price in times like these for the civilization which permits the transfer of property on death to persons of one's own choosing.

Chapter 38

SOCIAL SECURITY

"Our basic objective—toward which all others lead," President Truman declared in his annual message in January 1946,

> is to improve the welfare of the American people. In addition to economic prosperity, this means that we need social security in the fullest sense of the term. . . .

Our social security system is intended to provide a cushion against the hazards of old age, dependency and unemployment. At the same time, the collection and disbursement of social insurance funds affects both the size and the distribution of national income. Our policy of financing the system must be reappraised and the program, itself, must be broadened and strengthened, if it is to become a more perfect instrument for maintaining economic security throughout the country and high levels of employment and income.

Today we have three basic social security programs: old-age and survivors insurance, unemployment compensation and public assistance. Old-age and survivors insurance is administered entirely by the Federal Government. Unemployment compensation is administered by the states under their own laws, subject to certain Federal limitations. Public assistance is administered by the states according to general standards laid down in the social security law.

1. *Financing Old-Age and Survivors Insurance*

Old-age and survivors insurance is financed by a pay-roll tax on employers and employees based on the first $3,000 of the employee's annual wages in covered employment. The "contributions" represented by these taxes go into a trust fund in the United States Treasury from

which benefits and administrative expenses are paid as they are needed. The money in the trust fund not needed for current expenditures is invested, like the funds of banks and life insurance companies, in government obligations.

While financing old-age and survivors insurance involves certain considerations peculiar to the special nature of the program, it involves other considerations which are common to all public financing. One of the latter bears upon an important question of tax policy. That question is the extent to which pay-roll taxes, as contrasted with general revenues, should be used to finance benefits paid. Is it more advisable to build up large reserves in early years through pay-roll taxes which exceed current benefits, or to keep contributions relatively close to benefit payments with the expectation that the government will eventually step in with a subsidy? The answer turns on whether actuarial needs or a revenue system designed to promote a high level of consumption and employment should be the primary consideration.

In the beginning the old-age insurance system was designed to operate on a so-called full reserve basis. This plan calls for rapidly rising rates of contribution in the early years up to a level rate and the creation of a large reserve, the earnings of which can be drawn upon to lighten the load in future years when total benefit payments are certain to increase. An alternative to a full reserve is a pay-as-you-go system which necessitates little or no reserve and contributions more nearly keyed to benefit payments in each year.

While Congress has apparently committed itself to a long-run financial policy on social security, this policy has been obscured by the tax rates in the law. Under the original schedule the tax rates on employer and employee were to begin at 1 percent and increase at intervals over a period of twelve years until the rate for each would level off at 3 percent in 1949. It was estimated that the reserves resulting from the program would be built up to approximately $50,000,000,000 by 1980. But before the first rate increase became effective, Congress held the tax at 1 percent for three additional years. Since 1942 the rate has been frozen at 1 percent for successive years through 1947. The fund, plus interest, stood at more than $8,000,000,000 on December 31, 1946.

In 1939 the Social Security Act was amended to require that the board of trustees of the Old-Age and Survivors Insurance Trust Fund

should report immediately whenever the board was of the opinion that during the ensuing five years the fund would exceed three times the highest annual expenditures anticipated during the five-year period, and whenever the board was of the opinion that the amount of the trust fund was unduly small. The 1939 amendments embodied the idea of a contingency reserve, a relatively small fund which would obviate the necessity of imposing hurried special taxes in the event that claims rose suddenly. The contingency reserve principle appeared to repudiate the actuarial, or "full," reserve principle without eliminating it. In effect, Congress took the position that a reserve in the minor role of a contingency fund constituted sufficient permanent financing of old-age and survivors insurance obligations. When the pay-roll tax rates were frozen for 1944, a step was taken toward financing the old-age and survivors insurance program partly out of general taxation; Congress authorized government contributions for old-age and survivors insurance, if receipts from pay-roll taxes should become insufficient. That this step was not altogether firm was evident during the passage of the Social Security Amendments of 1946 when the House lost in conference an amendment repealing this section of the Social Security Act.

There has been much debate and more confusion over the wisdom of accumulating a huge reserve and over the principle of financing social insurance on a pay-as-you-go basis. Those who favor higher pay-roll taxes and the attendant substantial reserve look at the problem largely in terms of traditional private insurance practice. They contend that a financially sound insurance plan requires that a reserve be built up in rough proportion to the obligations being incurred. Such a plan would be self-supporting. Behind this philosophy lurks a fear that when Congress has to make up deficits by appropriation, or votes to finance part of social security benefits out of general revenues, that will be the end of social security as a matter of right and a return to the dole. This group further believes that unless pay-roll taxes are raised soon, many people will gain the impression that benefits are less expensive than they actually are, and will exert pressures to set up a runaway scale of payments which ultimately cannot be met.

Those who favor a lower tax rate at this time contemplate a system predicated more largely on a pay-as-you-go basis and substantial government contributions when the program comes into full operation.

They cite the essential difference between private financing and government financing; a full actuarial reserve is unnecessary in a government-operated plan, since the government can secure continued contributions through taxes, relying on progressive taxation as a major source of revenue. Such a course would be in line with nearly all old-age benefit systems in other countries. This group takes a diametrically opposite view of the effect of increasing pay-roll taxes. They believe that an ever-growing reserve fund would be a direct invitation to increase benefits.

In evaluating these two opposing viewpoints the question of equity cannot be ignored. It may be argued that as long as large groups of citizens are excluded from the old-age and survivors insurance system support should be related to coverage and general revenues should not be used to finance benefits. But this reasoning fails to take account of the fact that pay-roll taxes may in the long run affect the prices which the general public pays for many products, so that to some extent the general public may indirectly subsidize benefits. It also ignores the fact that the government finances other expenditure programs for selected groups, such as subsidies for farm products and air lines, out of general revenues. It might also be argued that those now covered by the old-age and survivors insurance system should pay a lower tax rate than those who come under the system in later years because those now covered are required to support many aged persons who are outside the insurance program.

Furthermore, the Federal Government cannot practicably create a reserve in any form except its own obligations. Consequently, social security reserve accumulations in excess of current needs are used for whatever current expenses the government is required to meet. Since the pay-roll tax is imposed on all covered workers alike with no regard for ability to pay, the great mass of contributions not used immediately for benefit payments constitutes regressive taxation to meet current governmental costs.

Nor can we overlook the equity point that people of sixty-five and over who retired before old-age and survivors benefits became effective were cut out from under the system, whereas those people who were approaching sixty-five and worked only two or three years in covered employment are now receiving benefits out of all proportion to the

contributions they have paid. If coverage is extended in the future to groups now excluded, a similar equity problem will arise. However, insofar as incommensurately large benefit payments go to people in the low income brackets, additional funds are placed in the hands of people who will spend them entirely for consumption goods.

One of the best reasons for departing from the reserve plan and adopting a pay-as-you-go system with part of the cost of benefits to be met from general revenues now—rather than waiting until present pay-roll taxes prove insufficient—is that in a nation which in most periods saves more than is economically healthy economic activity would be stimulated. Large reserves withdraw much greater amounts from the economy than are replaced by benefits and, therefore, tend to intensify our oversaving problem. Under a pay-as-you-go system, for the next several decades tax revenues required to maintain a given level of benefits would be reduced and a higher level of general purchasing power would be maintained. The lowest income groups, who are suffering from a deficiency of purchasing power, now bear a large part of the social security tax load at the expense of current consumption. They are forced to save money that they would otherwise spend. If their tax burden were lightened, they would spend more and consume more. At the same time the use of general revenues obtained from progressive taxation would relate costs of the system more closely to ability to pay than at present, and cut down savings in the higher income groups where most savings occur. As things now stand, pay-roll taxes on the higher income groups merely divert savings from securities, or bank deposits or private insurance to social insurance.

If pay-as-you-go financing and government contributions to social insurance were linked up with expansion of social security benefits, the total effect in combating oversaving would be especially pronounced. Moreover, if a very large proportion of the population were protected under the system, a government contribution from general tax funds would unquestionably be warranted. For even persons who did not share directly in the system would benefit indirectly from its stabilizing effect upon the whole economy. Once social insurance is accepted as a public responsibility that conveys indirect benefits to all members of the community, it becomes appropriate to draw upon general revenues. Then the right to benefits and the guarantee that future obligations will

be met will not depend upon individual contributions, nor the reserves built up from those contributions, but rather on the harmony of social insurance with the nation's over-all economic and social objectives.

2. *Operation of Old-Age and Survivors Insurance*

The benefits under the Social Security Act constitute the end for which the taxing provisions supply the means. Old-age and survivors insurance includes both retirement benefits and life insurance benefits. It provides monthly benefits to a fully insured worker who retires at sixty-five, to his wife at sixty-five, and to his children until they are eighteen. When a fully insured worker dies, monthly benefits are paid to his survivors, if they meet certain requirements as to age and relationship. To be fully insured a worker must have at least forty quarters of coverage, or have one quarter of coverage for every two quarters since January 1, 1937, or since he was twenty-one. A widow and children may also receive benefits if the worker was currently insured. To be currently insured a worker must have had at least six quarters of coverage during the three years immediately preceding his death.

Benefits are based on the worker's earnings and length of employment; they begin at $10 a month and may run up to $85. The same benefit formula is used throughout the country, but the prevailing levels of payments differ from state to state according to the prevailing wage levels. If a retired man and his wife are to receive the maximum of $85, the man must have more than forty years of coverage and an average monthly wage of $250. Very few families are eligible for the maximum amount. In 1943, for example, the average monthly benefit received by a retired worker and his wife was $39. If an insured worker dies leaving no survivors qualified for monthly benefits at the time of his death, a lump sum equal to six times his monthly benefits is paid to his survivors, or to the persons who pay his burial expenses.

The 1944 Republican platform recognized the most urgent single need in the old-age and survivors insurance program when it pledged extension of the system to all employees not already covered. Our basic insurance program now covers less than three-fifths of those who earn a living. Among the large groups not covered are agricultural and domestic workers, government employees, workers in non-profit organizations and the self-employed.

The size of the uncovered groups does not tell the whole story. Many workers shift back and forth from covered jobs to jobs which are not covered by the social security system. Because of this patchwork coverage the benefits of these workers are reduced or the workers may fail to qualify for any benefits, even though they contribute to the system when they have taxable wages. If a worker changes from covered employment to a job under a special system, such as civil service retirement or railroad retirement, the resulting division of coverage may work out so that he can receive only a minimum monthly benefit under either or both systems, or so that he cannot qualify under either, although he may have contributed to both. If he changes from noncovered employment to covered employment, a worker may build up credits toward an annuity benefit; but if he later returns to his former employment he may derive no benefits from the contributions he has made. At the end of 1946 more than 75,000,000 workers had received wage credits at some time since the old-age and survivors insurance program went into operation, but less than half of those workers had been long enough or steadily enough in covered employment to make them or their survivors eligible for benefits in the event of retirement or death.

Another basic weakness of the old-age and survivors insurance system is that benefits do not actually represent basic protection. The benefit amounts were fixed in 1939, and payments now are far from adequate. In 1946 the average family benefit was $29.40. In many cases insurance benefits must be pieced out with public assistance payments. While a considerable proportion of the beneficiaries have additional resources, most of them have been hard pressed by the steep rise in the cost of living. It seems beyond question that retirement benefits should be liberalized. Extension of coverage so that all earnings could be counted in computing benefits, instead of earnings only in covered employment, would improve benefit levels for many workers. Raising the wage base for both contributions and benefit-computation purposes to the first $3,600 a year, rather than the first $3,000, and increasing the maximum benefit from $85 a month to $120 a month would recognize the general increase in wage levels and result in benefits representing a larger proportion of the wage loss sustained by families in the middle income brackets. More adequate benefits for low-paid workers could be attained by a different weighting of the present

benefit formula. Increasing the amount of permissible earnings beyond the $15 a month a beneficiary is now allowed to earn without suspension of benefits would correct a condition which puts workers in the dilemma of sacrificing either inadequate benefits or inadequate earnings. Reducing from sixty-five to sixty the age at which women may qualify for benefits would be a boon to women, who have greater difficulty than men in keeping jobs after they are sixty, and would alleviate the hardship caused when a man is forced to retire at sixty-five and the supplementary benefit to his wife, who is very likely to be younger, may not be paid for several years.

As a first step toward correcting the weaknesses of our existing old-age and survivors insurance system, in March 1945 the House of Representatives authorized the expenditure of $50,000 to enable the Ways and Means Committee to make a study of the need for amendment and expansion of the Social Security Act, with particular reference to old-age and survivors insurance. The committee appointed a technical staff which issued a voluminous report early in 1946. From February 25, 1946, to June 7, 1946, the Ways and Means Committee held numerous public hearings on social security. Witnesses came from all parts of the country to testify, on the expectation that the committee was making a complete revision of the social security laws. The result, however, was the Social Security Act Amendments of 1946, passed in August, which failed to deal with the most important aspects of social security. Chairman Doughton explained that the amendments did not represent "the final consideration of social security legislation" by the Ways and Means Committee, but should rather be regarded as a temporary measure designed to freeze the old-age and survivors insurance tax rate and to liberalize public assistance grants for the next year, while permanent changes in both the insurance and public assistance programs were being perfected.

Because of the dissatisfaction expressed by many members of Congress with the inadequacies of the 1946 Amendments, Mr. Doughton subsequently requested the Treasury to make a study of social security and present recommendations to the Ways and Means Committee. Meantime, on August 2, the last day of the Seventy-ninth Congress, the Senate passed a resolution directing the Finance Committee to make

> a full and complete study and investigation of old-age and survivors insurance and all other aspects of social security, particularly in respect to coverage, benefits, and taxes related thereto. . . .

The resolution authorized the expenditure of $10,000 for the Finance Committee study. In his Budget Message in January 1947, President Truman voiced the "hope" that the studies already undertaken by Congressional committees would "result in prompt expansion and integration of the present social security system."

3. *Financing Unemployment Compensation*

Unemployment compensation is operated by the states and is financed out of pay-roll taxes levied upon specified employers only, except in four states in which employees also contribute. The Federal tax is 3 percent on the first $3,000 a year paid to each worker. In actual practice, however, employers pay only a fraction of the Federal tax since they may offset as much as 90 percent of the state tax against it. As a result, the states have generally established their standard rate as 90 percent of the Federal tax, or 2.7 percent.

The proceeds of the state tax go into a state unemployment fund which is deposited to the state's account in the Unemployment Trust Fund in the United States Treasury where it is held until it is requisitioned by the state to make benefit payments. The 10 percent of the Federal tax which cannot be offset is paid directly to the Federal Government, which finances the entire cost of state administration of unemployment compensation.

By the end of 1946, the reserve funds of state agencies totaled almost $7,000,000,000. Since unemployment compensation is designed to replace part of the wages lost by insured workers who are unemployed, the amount of unemployment compensation paid out varies with the volume of unemployment. In 1940, benefits amounting to nearly $520,000,000 were paid out, while in 1944, when wartime production was at its height, benefit payments amounted to less than $63,000,000. Benefits during 1946 amounted to a little over $1,000,000,000.

The 2.7-percent standard state unemployment tax rate is modified in most states through the operation of experience rating provisions which relate an employer's tax rate to the amount of unemployment among his former workers. Under this plan employers with relatively stable employment may obtain reduced tax rates. In 1946 experience rating cut the effective tax rate to a national average of 1.4 percent. Despite the reduced rate, however, employers receive full credit under the Federal tax.

Experience rating was originally justified as an incentive to employers to provide stable employment and as a method of allocating the social costs of unemployment to individual business concerns responsible for those costs. Its justification as an incentive to stabilize employment rests on the dubious assumption that individual employers have a substantial degree of control over unemployment and that differential rates will be an effective inducement to employers to stabilize their operations. It is a question whether possible reductions in tax rates can ever be an effective stimulus to employment stabilization. Any tax savings that might be offered would very likely add little or nothing to the financial incentives employers already have to regularize their operations.

While the idea of rewarding employers for stabilizing employment may be superficially attractive, it fails to take account of some of the salient facts of present-day economic life. A conscious effort by employers can minimize some short-run causes of unemployment, but a preponderance of evidence indicates that the major causes of unemployment are beyond the control of individual employers. Fluctuations in the general level of employment are largely due to national and international forces which individual employers are practically powerless to regulate. The tax reductions of the last few years resulted from the high level of employment induced by war activities rather than from any efforts of employers to stabilize employment. Moreover, stability of employment may mean something else than keeping the same person on the same job. It may very well be considered as stability of the entire volume of employment afforded by the national economy within a given period of time. This interpretation makes allowance for, and even encourages, as much fluidity in individual employer-employee relations as our economy may require.

So far experience rating has operated as a device for tax reduction when economic requirements dictated increased taxes and business was best equipped to bear them. In general, the state systems are so constructed that experience rating produces relatively lower tax rates in prosperous times and relatively higher tax rates in periods of high unemployment. Any device which results in higher rates, when employers are least able to pay them, is likely to have a destabilizing influence on employment.

Under the concept of experience rating as an incentive to stabilize employment, the differential tax is viewed less as a revenue measure to

finance unemployment benefits than as a tax to discourage unemployment and thereby eliminate the need for benefits. No experience rating system takes the positive approach of rewarding the employer who expands his volume of employment. Experience rating may rather penalize him, since any increase in his working force will subject him to a higher tax rate, if he fails to give all of his employees continuous employment and the workers who are laid off draw benefits.

The second justification of experience rating—that it is a method of allocating the social costs of unemployment to individual employers—is partly an expression of the view that the unemployment tax should be reflected in the prices of goods produced. If some of the tax is passed on in the form of higher prices, consumers pay more for the products of industries which use a large labor supply than for the products of industries in which labor is a smaller factor in production costs. If a shifting of the tax occurs, the objective of cost allocation is reached to the satisfaction of those who consider it a desirable objective.

Experience rating is also vulnerable to the charge that it violates two accepted principles of taxation—uniformity and certainty. Experience rates are determined on an individual employer basis in each state. As a result unemployment compensation taxes fluctuate from year to year and vary widely from industry to industry and from state to state. The average employer's prospects of securing a reduction in his tax rate depend less on his success in preventing unemployment than on the general level of employment, his particular industry and the place in which his business is located. Employers in competing lines of business with similar unemployment experience pay widely different rates depending upon the benefit and eligibility provisions of the laws of the states in which they operate. Inevitably, experience rating has degenerated into a system of competitive bidding for tax reductions among the states. One effect of interstate competition has been to place a powerful brake upon improvements in state unemployment compensation systems.

Whether the cost of unemployment insurance should be met entirely by employers, or whether it should be shared by employees, or whether it should be shared three ways—by employers, employees and the Federal Government—or whether the Federal Government might better bear the entire cost, are questions worth serious consideration. To the extent that employees shared the cost, they would have the com-

fortable feeling of having paid for what they received. On the other hand, it can be argued that unemployment is very largely beyond the employee's control and that he should not be forced to pay for insurance protection. Moreover, a system which permits variable rates for employers is hardly compatible with a system supported jointly by workers and employers. A Federal contribution from general revenues offers the advantage that it would be more conducive to maintaining high levels of employment than a pay-roll tax, which is one of the worst types of tax in terms of encouraging an expanding volume of employment. Insofar as the unemployment tax is passed on by employers in the form of higher prices paid by workers and society as a whole, the burden would be more equitably distributed if the entire cost were borne by the Federal Government. In the long run, the sources of funds for any social insurance benefits should be a matter of fiscal, rather than social insurance, policy.

Another major shortcoming of the existing method of financing unemployment compensation is inherent in the segregation of benefit reserves in the Unemployment Trust Fund into individual state accounts without provision for pooling or reinsuring on a national basis. This segregation limits the potential use of the reserves. Since employment risks differ in various states because of economic and natural factors, the geographic units represented by the states are not effective units for bearing the costs of unemployment.

Inasmuch as the accumulated state reserves in the Unemployment Trust Fund are now clearly larger than necessary for a current-risk program, the Social Security Board, in its final report made in February 1947, recommended a revised method of financing. If a Federal-state system of unemployment insurance is continued, the board would abolish the credit-offset features of the present tax and substitute a straight Federal tax of 1 percent of covered pay-rolls, from the proceeds of which matching Federal grants to the states would be made for both benefits and administration. This system of Federal grants-in-aid would solve many basic administrative problems and simplify present financing. The wide variations in employer contribution rates would be lessened and states would have far greater flexibility in financing benefit costs. The grant-in-aid plan would also provide an element of reinsurance, since a state which experienced considerable unemploy-

ment would receive a relatively larger share of Federal funds than a state with a better employment record.

If the credit-offset feature of the present tax is retained, however, the board recommended that the Federal unemployment tax be reduced from 3 to 2 percent and that employers be permitted to offset as much as 1⅘ percent for contributions made or excused under state laws. The board further suggested that authority be given the states to permit state-wide reductions in contribution rates below the 1⅘-percent rate on any basis they deem best, not merely, as at present, on the basis of the individual employer's experience with unemployment.

In July 1946, under President Truman's Reorganization Plan No. 2, the functions of the Social Security Board and its chairman were transferred to the Federal Security Administrator. From time to time, however, the board has affirmed its conviction that the national problem of wage loss from unemployment could be handled more expeditiously and economically by means of a national social insurance program. A national program offers distinct advantages. The financing of unemployment benefits could be related far more closely and constructively to the economy as a whole than is possible when financial arrangements hinge on different concepts and procedures incorporated in state laws and require the action of state legislatures for adjustment to changing conditions. Under a comprehensive social insurance program, unemployment benefits could be related appropriately to benefits for other risks and many additional administrative savings could be made. A national system of unemployment insurance—either as a separate system or as a part of a comprehensive program including social insurance against other major risks of wage loss—in the words of the Social Security Board, "offers the course best suited to the development of adequate and equitable provisions for unemployment insurance in the United States."

4. *Operation of Unemployment Compensation*

In examining our unemployment compensation system from the standpoint of its capacity to relieve workers from the terrors of payless joblessness, a number of defects are visible to any objective eye. As with old-age and survivors insurance, unemployment insurance cover

age is still too narrow. Millions of people are not covered at all because they work for Federal, state and local governments, or for small employers, or because they are in domestic, agricultural or nonprofit employment. If workers are to be given carrying power against wage loss from unemployment, unemployment insurance should be extended to additional categories of jobs. It can hardly be argued that the national interest is served by treating some groups of citizens differently from other groups, when the only essential difference among them is the kind of work they do or the size of the firms in which they are employed.

Another weakness of our unemployment compensation system is that benefits are completely inadequate to serve as a strong first line of defense against unemployment. It is the province of the state legislatures to determine the amount of weekly benefits and the number of weeks for which benefits will be paid. As a consequence, benefits vary widely among states both as to amounts and duration, but by no stretch of the imagination can the benefits paid in any state be regarded as a substitute for full-time wages. Largely because of the limitations in state laws on the maximum amount that can be paid, benefits have failed to keep pace with rising wage levels and the rising cost of living. Unemployment compensation was originally designed to replace at least 50 percent of the weekly wage loss. But in most states the *maximum* weekly benefit is less than half of the *average* weekly earnings of covered workers. In 1946 only seven states paid a maximum weekly benefit of $25. Except in four states—Connecticut, Michigan, Nevada and Massachusetts—and the District of Columbia, no account is taken of dependents. Extension of coverage would be of little advantage to low-paid workers, unless the benefits paid provided at least a minimum of subsistence. But as long as benefits are pegged in relation to past wages, there can be no assurance that benefit payments would meet that requirement, particularly for workers with family obligations.

The average worker may expect to receive benefits for about twenty weeks. In only one state can all insured workers receive benefits for as long as twenty-six weeks. But no state yet provides for both a uniform duration of twenty-six weeks and a maximum weekly benefit of $25. Almost three-fourths of the states gauge the duration of benefits according to the amount of the worker's past earnings. In twenty-one states some eligible workers are still limited to less than eight weeks of bene-

fits. In contrast, in fourteen states any eligible worker may draw benefits up to the maximum number of weeks specified in the state law. In these states the amount of the weekly benefit, but not the duration, is determined by past earnings. When benefits are of too limited duration, the worker's insurance is likely to run out when he needs it most. In 1946 more than 1,000,000 workers, representing about 40 percent of all beneficiaries, exhausted their benefit rights before they found other jobs.

If unemployment compensation is to provide security from economic hazards over which individuals have no control, and assist in maintaining a high level of consumption, benefits should be made large enough to sustain at least a minimum standard of decent living. They should be extended in duration to give workers at least a reasonable opportunity to find suitable jobs. The maintenance of the purchasing power of unemployed workers and their families goes beyond welfare policy; it is a basic component of a prosperous economy. A refusal to make benefits more adequate, defended in some quarters on the ground that the unemployed would not work if benefit payments were increased and extended, overlooks the fact that workers cannot voluntarily retire to a state of idleness and draw unemployment compensation under a properly administered state system. To be eligible for benefits, workers must have sufficient wage credits and must also meet tests of their current attachment to the labor force and the genuineness of their unemployment. If suitable jobs are available, workers must accept them or lose their benefit rights.

Severe disqualification provisions in many state laws cancel or reduce a worker's benefit rights or postpone benefits unduly. Some of these provisions have been included largely because of experience rating. There is no question that state laws should contain provisions which disqualify a worker from receiving benefits, if he quits a job or refuses suitable work without good cause, if he is discharged for misconduct, or if he is participating in a labor dispute. These provisions are necessary to limit the risks covered by the unemployment compensation program, but they should not be imposed solely for punitive purposes. Disqualification provisions should prevent the payment of benefits for voluntary unemployment, but they should never completely bar payments to eligible workers who are involuntarily unemployed and able, willing and available for work. Some states have limited the definition

of "good cause" for leaving a job to causes attributable to the employer. In these states, for example, a man who has left a job on promise of work that did not materialize, or to have an operation, may not be able to draw any benefits, despite the fact that when he is ready and able to work he cannot find a job. This situation could be ameliorated if suspension of benefits for a few weeks following the disqualifying act were substituted for the more drastic disqualification provisions now in effect. It could be further improved if the definition of "good cause" for voluntarily leaving a job and refusing suitable work were broadened to include compelling personal and family reasons.

5. *Public Assistance*

Through public assistance the social security program provides a method of giving aid to needy people who have had no opportunity to build up social insurance rights, or who have suffered catastrophes or met with misfortunes with which social insurance benefits and personal resources are inadequate to cope. According to the late Oswald Stern, public assistance, or social assistance, "is a progression from poor relief in the direction of social insurance." It complements social security; but it differs from the rest of the social insurance program in that other resources of the applicant for relief, including the resources of relatives, are taken into account.

The Federal Government makes grants-in-aid to states for public assistance for three groups who are unable to earn their own living—old people, blind people and dependent children. In 1946 more than 2,000,000 old people—about one aged person in five—were receiving old-age assistance. Aid was given to more than 57,000 blind persons and to about 800,000 children in more than a quarter of a million families. These benefits are not based on contributions, but on need. In the fiscal year 1946 the Federal Government paid out about $440,000,000 in grants to the states for public assistance.

One defect in our public assistance system is inherent in the provision under which the Federal Government matches state funds dollar for dollar up to a given amount. While the Social Security Act Amendments of 1946 liberalized the matching formula by departing from the 50-50 basis on the first $15 for the aged and blind and the first $9 for dependent children, the matching principle was basically preserved. The

increase in the share of Federal funds made available to all states on an equal basis took no note of the varying economic capacities of different states. In 1945 the difference in per capita income among the states ranged from $1,595 in the highest state to $556 in the lowest. As a consequence, states differ greatly in their assistance standards, and payments are smallest in states where poverty and need are greatest, because these states cannot afford to match Federal funds up to the maximum grant. The poorer states frequently devote a far larger percent of per capita income to public assistance than the wealthier states, but their greater efforts fail to show in actual dollars paid out. The matching requirement is an insurmountable barrier to adequate public assistance in these states and to an equitable public assistance program for the nation.

The amount of money payment which the Federal Government contributes for public assistance is limited on an individual basis. The 1946 Amendments placed the ceilings on the Federal share for old-age assistance and aid to the blind at $25, and for aid to dependent children at $13.50 for the first child and $9 for each other child. For the period ending December 31, 1947, a formula was adopted under which the Federal share is two-thirds of the first $15 of monthly payments for old-age assistance and aid to the blind and one-half of the remainder up to the over-all Federal maximum share of $25. Similarly, for dependent children, the Federal share is two-thirds of the first $9 of the payment and one-half of the remainder up to an over-all Federal maximum share of $13.50 or $9. The amount of assistance which the Federal Government shares with a state is therefore limited to a Federal-state total of $45 a month for a recipient of old-age assistance or aid to the blind, and $24 a month for the first child and $15 a month for each other child aided in a family receiving aid to dependent children.

The effect of the matching limitations is especially serious in aid to dependent children, because the amounts are lower than those for old-age assistance and aid to the blind and no allowance is made for the adults who care for the children. Since states tend to limit assistance payments to amounts which can be matched from Federal funds, the maximums specified in the Social Security Act hold down assistance in many states for the recipients whose need is greatest, especially families with one or two dependent children. Assistance of $24 a month for a mother and child, or $39 a month for a mother and two children is utterly insufficient unless the family has other resources. Nor is $45 a

month enough to provide an aged or blind person with the essentials for even minimum comfort and well-being.

Our public assistance system would be greatly strengthened if Federal grants were made on a variable basis. If a larger share of Federal funds went to the poorer states, the entire nation would benefit. All sections of the country are economically interdependent. Markets are nation-wide. State lines cut across present lines of economic development. Since the welfare of each state is intrinsic to the prosperity of the whole nation, it is in the national interest that all states should be able to provide a basic minimum of security for all of their needy people. Moreover, the needy aged, the blind, and dependent children should not be penalized because they happen to live in a state where per capita income does not permit a matching of Federal contributions. Aid should be granted on the basis of actual need, and need cannot be measured by state lines.

Our public assistance system would be further strengthened if Federal grants-in-aid were made to the states for general assistance to any needy person, wherever he lived and whatever the cause for his need. In some parts of the country general assistance is insufficient or wholly lacking; in many others it is sharply limited by the inadequacy of local funds or by legal and administrative restrictions on eligibility. There is no justification for limiting Federal grants to programs for the needy aged and blind and dependent children and excluding other persons who are in need because they are sick or physically or mentally handicapped.

6. *Disability Insurance and Medical Care*

Aside from limited coverage and inadequate benefits, the most serious gap in our present social insurance system is its failure to provide American workers and their families with any defenses against two leading causes of poverty and dependency—wage losses and costs of disability and sickness. Among workers who feel that they have fairly adequate protection against old-age insecurity and unemployment, there are relatively few who would not be reduced to dependency on relatives or public agencies if they met with a long period of illness.

On an average day 7,000,000 persons in the United States—about the population of New York City—are so disabled by sickness or injury that they cannot go about their ordinary business. About one-third of

this number would be at work, or looking for jobs, if they were not incapacitated. The other two-thirds—children, students, housewives and old people—are not members of what is conventionally regarded as the labor force. Over 1,500,000 of the persons who would have been in the labor force except for their disability have been incapacitated for more than six months, and therefore for social insurance purposes are "permanently" disabled. In the course of a year about one in every three or four wage earners is incapacitated by temporary sickness or disability.

Thirty-two countries have insurance against wage loss for temporary disability, and the United States is one of only three which insure temporary loss of earnings from unemployment without also insuring the loss from temporary sickness. Thirty-one countries have compulsory social insurance for wage earners against permanent disability; the United States is alone in insuring workers against old-age insecurity without also insuring them against permanent or chronic disability.

It makes little difference to workers whether they are unemployed because of lack of work or because of illness. As a matter of fact, the loss of earnings during temporary disability is likely to cause greater hardship than the loss of earnings during unemployment because of the additional expenses which sickness brings. Yet at the present time, most industrial workers are protected against loss of earnings from lack of work opportunities and not against loss of earnings from illness. Only two states—Rhode Island and California—have enacted temporary disability insurance laws. In these states the agency administering the unemployment insurance program administers the temporary disability insurance program.

In the Social Security Act Amendments of 1946 Congress provided an inducement for the states to expand their social insurance protection by including benefits for temporary disability. It permitted the states that have collected contributions from employees under state unemployment insurance laws to use the money to finance disability insurance benefits. Nine states—Alabama, California, Indiana, Kentucky, Louisiana, Massachusetts, New Hampshire, New Jersey and Rhode Island—at one time or another have collected employee contributions, some of them in substantial amounts. These employee contributions might well form the financial basis for embarking on systems of temporary disability insurance.

Permanent disability of the breadwinner almost always cuts down or stops the family income. In its effect on family security permanent disability is like old age, except that it involves additional medical costs and often comes at a time when a worker's family responsibilities are greatest and when he has had little opportunity to accumulate savings. Certainly, the man of twenty-five or thirty, who is a victim of tuberculosis while his children are still young, has an even greater problem to face than the hale and hearty sixty-five-year-old worker who retires by virtue of his age. There is urgent need to expand our social security system to insure workers against the loss of earnings from temporary and permanent disability and the costs of medical care.

Although we are the richest, we are not the healthiest country in the world. During the war nearly 5,000,000 young men failed to measure up to health standards for military service because of physical or mental defects which in many cases might have been prevented or corrected. Boys classified as "farmers" had a higher rejection rate than any other group. These figures relate only to men in the prime of life; in the whole population a far larger proportion of persons is handicapped by substandard physical or mental health. In the last of the prewar years six countries had lower infant mortality rates than the United States. From seven to ten countries—the rank differing for age groups—had lower death rates among children and adolescents, and eighteen to twenty-four countries had lower rates among persons aged thirty-five to sixty-four. Death rates in this country are higher among Negroes than white persons but, even if the figures are restricted to the latter, the United States death rate is by no means the lowest.

Health records differ widely among the states. If all states had had as low an infant mortality rate as one state had in 1942, some 35,000 babies could have been saved. If, in 1941, all states had had the tuberculosis rate of the lowest state, some 42,000 deaths could have been prevented, mostly deaths of men and women in the productive ages. This was about the number of the nation's fatalities at the end of nearly two and a half years of war.

Nevertheless it is true that a growing proportion of the population lives to middle and old age, when diseases attack more slowly. However, many illnesses which people experience at middle and old age could be prevented or greatly minimized if medical advice were sought at an earlier stage. Unfortunately, in a great number of places, particularly

rural districts and areas where income is low, there is no place to go. Both hospitals and doctors tend to cluster in concentrated urban areas. However, by far the most important reason for the lack of needed medical care and for the volume of charity work demanded of doctors, hospitals and the public is that families do not have the money to pay the costs of medical care, either on the emergency basis of a sudden disaster, or on a long-time basis of continuing prevention.

The vast majority of people in this country have incomes of less than $3,000 a year, which provide no safeguards against medical indigence when costly or prolonged illness strikes. Public opinion polls show that about 30 to 40 percent of the people put off going to the doctor because of the expense involved. One way out of this difficulty is to spread the costs of medical care. In 1946 only about 25 percent of the people had some protection against hospital and medical costs through voluntary prepayment plans and private insurance, and comprehensive protection was limited to less than 3 percent. Those who need full protection most can seldom afford it. Voluntary insurance has proved to be neither a complete nor an adequate answer. Obviously, the nation needs a program that will give an opportunity for medical care to all who need it.

Insurance against permanent disability, more hospitals and health centers and better health protection were pledged by the Democratic national platform as far back as 1940. In his annual message to Congress in January 1945, President Roosevelt declared "good medical care" to be an "economic right" of American citizenship. Ten months later President Truman reiterated President Roosevelt's statement and made five recommendations in a health message to Congress.

He proposed:

1. Federal grants to the states to aid in the construction and improvement of hospitals and other health facilities.

2. Federal grants to the states to expand public health services, including maternal and child health services.

3. Federal aid for medical education and research.

4. National health insurance providing for comprehensive physicians' services and hospital care, with supplementary provision through Federal grants to the states for medical care for needy persons.

5. Insurance benefits to replace part of the earnings lost by workers through temporary sickness and long-term disability.

The health insurance plan which President Truman suggested as an

extension of the social security program was expected eventually to require 4 percent of each individual's earnings up to $3,600 a year, which is about the average for individual medical care expenditures. How much of the total fund should come from insurance premiums and how much from general revenues, the President said was "a matter for Congress to decide." In making his recommendations Mr. Truman was urging what Mr. Justice Holmes used to call "one of the felt necessities of the time."

Immediately following the November message a bill to establish a national health program along the lines President Truman had set forth was introduced in Congress. But in July 1946 all efforts to obtain its enactment during the Seventy-ninth Congress were abandoned. However, three measures bearing upon President Truman's health program became law in 1946. The first authorized $7,500,000 for erecting and equipping hospital and related facilities in the District of Columbia to serve as a center for research and study of psychiatric disorders. The act also provided for increased Federal grants to the states for public health services with special emphasis upon mental health. The second measure authorized Federal grants to the states for hospital construction and surveys of hospital and health center needs. The third measure provided for expanded maternal and child health services. But, as Mr. Truman pointed out in his Budget Message in January 1947, the major problem of financing health care "still persists." He, therefore, again urged Congress to enact a health insurance program "which will make adequate medical care available to everyone and provide protection against the economic hardships of sickness." Such a program, he said, should be almost entirely self-financing through pay-roll contributions.

7. *The Wagner-Murray-Dingell Bill*

The most comprehensive measure so far offered to broaden and strengthen the social security program is the Wagner-Murray-Dingell bill, introduced in Congress on May 24, 1945. The bill establishes a national system of social insurance with benefits financed by a total contribution rate of 8 percent, of which 4 percent is paid by employers and 4 percent by employees on earnings up to $3,600 a year.

An unemployment insurance system is set up on a national basis. Benefits are payable for twenty-six weeks and, if funds are adequate,

may be paid up to fifty-two weeks. Weekly benefits for single persons range from $5 to $20 a week and are increased for workers with dependents up to a maximum of $30 a week. The waiting period before benefits may be paid is set at one week. Workers who are temporarily disabled through illness or injury are eligible for the same benefits after a one-week waiting period for a maximum of twenty-six weeks, and married women workers are entitled to benefits for an additional twelve weeks of maternity leave.

The old-age and survivors insurance system is broadened to include monthly cash benefits where the insured worker is totally disabled for six months or more before he reaches retirement age. These benefits are equal to those paid under old-age and survivors insurance.

The minimum retirement benefit is increased from $10 to $20 a month and the maximum benefit is raised from $85 to $120. The bill also reduces from sixty-five to sixty years the age when women become eligible for retirement and wife's and widow's benefits. The $15 a month which an individual is permitted to earn under existing law and still draw his insurance benefit is increased to $25 a month.

Coverage is extended to agricultural and domestic workers, and employees of nonprofit institutions. Self-employed persons are covered under all insurance programs except unemployment and temporary disability insurance. Employees of state or local governments may be covered under retirement, survivors, extended disability and medical insurance by agreement between the Social Security Board and the state or local government unit. With the exception of hourly employees of the Tennessee Valley Authority, Federal employees are not covered.

The bill creates a social insurance trust fund to which existing funds of the old-age and survivors insurance system are transferred. Provision is made, as under the present Federal old-age and survivors insurance law, for authorizing appropriations to the trust fund out of general revenues, whenever Congress deems it necessary.

According to Senator Wagner, the contributions provided in the bill will be sufficient to pay all insurance benefits for several years; the number of years will depend primarily upon employment conditions. It will be necessary, however, for Congress to decide whether the contribution rates eventually should be increased, or whether the government should contribute to the insurance system or whether there

should be some combination of contribution methods. In introducing the bill Senator Wagner expressed the hope that the government eventually would contribute about one-third of the total disbursements from general revenues raised by progressive taxation.

"A government contribution," Senator Wagner declared,

> is desirable because social insurance has a social purpose. It protects society as a whole as well as the individual and his family. . . . The expanded coverage and comprehensive protection proposed by this bill remove those objections to a government contribution which are valid with respect to a social insurance system covering only part of the population.

Under the public assistance program variable Federal grants are provided to the states for needy individuals, ranging from 50 percent to 75 percent of the amounts spent by the states, depending upon the state's per capita income.

Under the health provisions of the bill basic health services are made available to all of the people. Preventive medicine is extended throughout the country by broadening and increasing the existing system of Federal aid to the states for public health services and maternal and child health services. Federal grants-in-aid are authorized to meet the costs of medical care for needy persons, prepaid medical care is provided, and the quality of medical service and the advancement of knowledge are promoted through aid to medical education and research.

8. *The Economic Effects of Social Security Taxes*

The income flowing out in social insurance benefits has a healthy influence in supporting the purchasing power of the nation which, in turn, has a salutary effect upon investment expenditure. During periods of weak employment it offers lifeblood to a faltering economic system. Social insurance payments generally go to persons whose usual income has been reduced, or stopped, or is too little for subsistence. The payments are therefore soon spent for essentials and pass quickly into the stream of commerce by being turned over to the neighborhood grocer, the landlord, the clothing store, the coal dealer and others who provide the basic necessities of life. Moreover, the psychological value

of the sense of security occasioned by the knowledge that the payments will be forthcoming has an incalculable, but no doubt substantial, economic effect. Spending habits are maintained. For this reason benefit payments have a far greater effect than their absolute amounts indicate.

Many people argue that the existing social security taxes have a harmful effect upon the economy because they decrease spendable income. As a matter of fact, it was because they decreased spendable income that the Treasury in 1943 urged increased social security taxes as of "immediate service in diminishing the threat of inflation." But if we are to maintain a high level of employment and a high national income in the years ahead, spending power must be expanded. If it is too much reduced by pay-roll taxes the government should share the burden, securing funds from sources which will increase, rather than diminish, spendable income. If part of the payments for social security are derived from general revenues, a portion of the funds will be obtained from people with high incomes who now make no substantial contribution toward our social insurance system. Higher pay-roll taxes can then be left to operate as a brake in inflationary periods.

In an editorial on January 24, 1945, *The Wall Street Journal* called attention to recommendations by the Social Security Board for extended social insurance coverage and increased benefits. These were "troublesome" problems the core of which was, "Where is the money coming from?" That question cannot be "dismissed," the editorial continued, "by airily talking about putting the man above the dollar or ecstatically elevating 'human rights' above 'property rights.'" Essentially the same argument has been made by the Committee on Postwar Tax Policy, which has found it necessary to point out that proposed extensions of the social security program "cannot be given without corresponding additions to taxation." The committee is concerned lest the "whole objective of a solvent and prosperous economy may be lost by imposing financial burdens so great as to produce a collapse of the mechanism of private enterprise."

In a democracy the majority of the population may some day have a different and less cautious word to say. The question then may be not whether we can afford to do more, but whether we can afford to do less. However, the subject can be discussed on a completely realistic level. The British have done so, and it is time for us to do likewise.

Sir William Beveridge's report of November 20, 1942, discusses the

"money price" of British social security—a more generous system than our own—in terms that should satisfy the most hard-headed Americans. The system described in the Beveridge report divides the cost among employers, employees and the state, with the state paying, as it now does, more than half the cost. One of the most "impressive social facts of today," Sir William declares, is "the capacity and the desire" of the British people

> to contribute for security. . . . The popularity of compulsory social insurance today is established, and for good reason; by compulsory insurance, so long as it is confined to meeting essential needs, the individual can feel assured that those needs will be met with the minimum of administrative cost; by paying, not, indeed, the whole cost, but a substantial part of it as a contribution, he can feel that he is getting security not as a charity but as a right.

The answer, the report continues, is also clear for the employer.

> What he pays as an insurance contribution is part of the cost of his labour—from his point of view an addition to wages. At whatever reasonable point the employer's insurance contribution is fixed, it is a small part of his total bill for labour and of his costs of production; it is the sign of an interest which he should feel and does feel in the men whose work comes under his control.

The greater burden for the state, Sir William continues, comes not initially but in the future.

> This is a burden which cannot be escaped; the facts are inexorable; the older people will be here and will be maintained—if not by pensions in their own right, then at the cost of their individual families, by charity, or by pensions subject to a means test.

The facts are just as inexorable in this country, and the burden just as inevitable. Those who can work should be encouraged to go on working so that the burden will be as light as possible. And whatever burden remains should be fairly distributed among all of the people.

We still hear legalistic argument in the McReynolds vein that the federalization of the unemployment compensation system would be an invasion of states' rights. Sometimes the proponents of conceptualistic contentions of this order are sincere, but this type of argument is usually

the last refuge of desperate opponents of legislative developments that will hurt at an economic spot. At any rate, the argument hardly lies in the mouths of those who contended in 1935 that forcing an obligation upon the states was an invasion of states' rights. But this is perhaps a debating point. Going to the basic issue, it should be clear by now that unemployment is a national rather than a state problem. Its causes are beyond separate state control, and inhere in the national, and perhaps international, economy. If the problem is so broad, the necessity for solving it is equally great. We do not have to dismiss the validity of the doctrine of states' rights in its proper setting to conclude that this doctrine need not interfere with the general welfare of the nation.

The argument is sometimes made that social security destroys individual initiative and responsibility and corrupts those qualities of thrift which have made the United States a great nation. We can bypass the point that the individual virtue of thrift may not be a collective virtue where the capital markets cannot absorb savings. The contention can be met face to face. Social security is not a plan for giving everybody something for nothing. The program provides insurance; that is all. It distributes the risks of various disasters among all the people just as a life insurance company distributes the risk of death among its policyholders. It is a plan for bringing the magic of averages to the rescue of millions.

More than a century ago, a committee in the British House of Commons pointed out the most economical way of guarding against the risks that face large numbers of the population:

> "Whenever there is a contingency, the cheapest way of providing against it is by uniting with others, so that each man may subject himself to a small privation, in order that no man may be subjected to a great loss. He, upon whom the contingency does not fall, does not get his money back again, nor does he get for it any visible or tangible benefit; but he obtains security against ruin and consequent peace of mind. He, upon whom the contingency does fall, gets all that those, whom fortune has exempted from it, have lost in hard money, and is thus enabled to sustain an event which would otherwise overwhelm him."

No sensible person proposes that the social security system provide more than a minimum of subsistence; individual initiative will have

plenty of scope after that. We may very well ask whether we give individual initiative the chance it deserves where we fail to provide a minimum of food and health for workers and their children. It is not so easy to be teeming with enterprise when your youth has been lived in crowded rooms with too little nourishing food. After all, it is hope, not fear of starvation, that must be relied upon to provide the initiative we shall need in the future. Our war experience with employment showed that the American people possess the basic instinct for work rather than idleness. It showed that workers take jobs promptly when jobs at adequate pay are available, regardless of whether they have social insurance. It showed that our social security program does not sap initiative or serve as a prop for the lazy and shiftless.

In 1935 we embarked on a social security program. The question now before us is how we shall improve it. The Atlantic Charter, endorsed by thirty-two United Nations, proclaimed that these nations desire to bring about the fullest collaboration in the economic field with the object of "improved labor standards, economic advancement, *and social security*." That great purpose will not dissipate in the future, but will grow. It is an essential of durable prosperity and peace.

Chapter 39

CORPORATION TAXES

1. *Consumption versus Investment*

THE effect of taxes on business activity is an old story. It was the ultimate preoccupation of Adam Smith, who held that taxes may be high and profits may still be high, "because the profitable employments of capital may be numerous." It is a story that interests almost everyone these days, however greatly the reasons for this interest may vary in different quarters. The stockholders of about half of the 500,000 existing American corporations are interested for the good and immediate reason that their corporations are subject to tax. Many stockholders of the other half hope for better days when profits will make taxes a problem. The stockholders of the profitable corporations are interested because most of them think that they bear the burden of the taxes paid by their corporations, though they sometimes adopt the views of those who maintain that it is the wage earners and consumers who pay. Still others are less directly, but no less surely, interested in corporation taxes because they are certain that a heavy tax load is inevitable for many years to come, and that they will bear, in the form of increased individual income taxes or excise taxes, the burden of any tax which the corporations escape.

The abrupt ending of the war catapulted the nation into a reconversion period which raised a number of special immediate problems in the field of corporate taxation. We are now confronted with a different set of problems with implications extending to the kind of social and economic order we shall have for a long time to come. Our task and responsibility is to secure an efficient economy with high levels of employment and income. At the outset we must remove every obstacle in our way, including any that may inhere in our corporate tax structure.

An efficient economy with high levels of employment and income is an ambitious undertaking. First of all, it requires that consumers, business and government spend enough to support a high level of income. We are particularly interested in maintaining high levels of consumption and investment. There is widespread agreement that these general objectives are desirable. But unanimity ceases when we pass from broad aims to specific methods of realizing them; then disagreement becomes acute and even bitter at times. Emotions are instantly involved in any discussion of concrete steps to attain high levels of consumption and investment, and the variety of suggestions offered is complete, stretching all the way from a return to the nineteenth century economic system to wholly new patterns. In the resulting confusion it is important to adopt the most realistic approach of which we are capable.

From the tax standpoint it is necessary first to recognize an awkward dilemma. If we deliberately set out to increase consumption, we find that certain taxes, such as pay-roll taxes, excise taxes and low bracket income taxes are inimical to our objective. These taxes are borne by low income families who consume a large proportion of their income, and consequently are reflected in smaller expenditures for consumption. The obvious way to stimulate consumption is to reduce this tax pressure on consumption. But if we have a fixed revenue goal, we are driven over to middle and high bracket income taxes, estate and gift taxes, and corporation taxes to make up the difference. To the extent that these taxes are not shifted to those who pay low bracket income taxes and excise taxes, they do not significantly affect consumption. This is to the good. But middle and high bracket income taxes and corporation taxes may, under some circumstances, deter investment. This is to the bad.

We are thus forbidden by a conflict of objectives from moving in the only two directions that appear possible; taxes which encourage consumption discourage investment. In the area of conflict we must choose to favor one or the other of our objectives. This does not mean that we must entirely abandon either; the problem is not necessarily insoluble. It is one of emphasis, requiring the most delicate judgment, based on knowledge of the functioning of the economic machine. In synthesizing the seemingly irreconcilable demands of consumption and investment we shall have to decide what part of our de-

sires can be discarded as least essential and what combination of taxes will carry us nearest to our goals.

If we decide to make a determined attack on deterrents to investment, we are confronted with another difficult problem. Obviously, nothing is gained in terms of total demand for the products of industry if tax pressures on consumption are lifted by, perhaps, $1,000,000,000, while investment expenditures are cut down by the same amount. In terms of total tax burden on investment funds the combined rates under the individual and corporation income taxes are an important consideration. But regardless of the rates there remains the question: What combination of the two tax pressures will be least detrimental to investment?

Where investment decisions are made by corporation executives, guided, perhaps to some extent subconsciously, by their interest in corporate profits and without full regard for the woes of their stockholders, the corporation tax will undoubtedly deter investment more than the individual income tax. Where decisions are made by the individual investor, theoretically it may make no difference whether the corporation pays the tax before dividends are distributed, or the investor pays the tax later on, if in either case dividend income bears the same total tax burden. But, practically, other motivations are involved. The individual investor's choice between corporate and individual taxes may very well be governed by his conception of the incidence of the corporation tax, by the extent of taxation of undistributed profits and by the alternative necessary to replace a lower corporation tax. If that alternative is a highly progressive individual income tax, he may prefer a tax at the corporate level. In the end his answer will depend upon the specific tax proposals which he compares.

How to stimulate investment by individuals raises further questions. Which income ranges can be expected to furnish the main source of investment funds? Here our ignorance reaches deeper roots. Do these funds come primarily from the recipients of incomes under $50,000, or the recipients of incomes between $50,000 and $100,000, or the recipients of still larger incomes? No one knows the answer to this question. Economic research has been going on for many years, but we are still without an adequate analysis of the income ranges which are most strategic from the investment point of view. Here again we shall prob-

ably have to act before we can achieve full knowledge, but it is important at least to know that we shall be proceeding upon the basis of hypotheses rather than facts.

2. *Who Pays the Corporation Tax?*

In choosing between taxes which discourage consumption and taxes which deter investment the corporation tax presents a special problem. We do not know where the burden of this tax finally falls. Some people contend that the tax is shifted to consumers and wage earners. To the extent that it is shifted to consumers in the form of higher prices it becomes, in fact, an excise tax or concealed sales tax—although in this role it is perhaps a less efficient instrument than a direct sales tax—and cuts capacity and incentive to spend. To the extent that it is shifted to wage earners in the form of lower wages, it also has a tendency to reduce consumer expenditures. These two effects work hand in hand. To the extent that the corporation tax is paid by the owners of capital, it represents an additional personal income tax.

It is unfortunate that there is, perhaps, no tax about the incidence and effects of which we know less. No statistical evidence is available. Business opinion differs and economists do not present a united front. The answer to the question whether substantial reduction of the corporation tax would lower prices, raise wages or increase dividends is, therefore, not available. Consequently, we cannot estimate the effects of corporate tax reduction upon consumption and investment. Such analyses as have been made indicate that under normal competitive conditions large amounts of taxes probably are not shifted to prices and wages. Many economists argue that a tax on net profits does not affect wages or prices because in the economic sense the tax is not a cost of production. In a competitive market prices are supposed to be set by conditions beyond the control of individual firms. Where a monopoly occurs, prices are presumably set at the most advantageous level in the light of demand and costs. In general, prices and output are set to obtain the highest profits, and the highest profits before tax will yield the highest net income after tax. Over the long run it is hard to prove that the corporation income tax has induced a general price increase, and it is certainly unlikely that elimination of the tax would result in a substantial lowering of prices.

There is so much disparity from firm to firm and from industry to industry in the relationship of the wage bill to corporate profits and taxes that it is almost impossible to determine the extent to which the corporation tax affects wage rates. Even if the tax has depressed wages in the past, its reduction would not necessarily push wages up in the future. Some powerful unions might be able to capture for their members a portion of any tax cut, but this would not happen uniformly, and perhaps not even generally.

It is reasonably certain that shifting the corporation tax to consumers and wage earners would have extremely unfortunate economic effects, if complete shifting were accomplished. A high national income and full employment depend upon high consumption, and any tax which bears unduly upon consumption places prosperity farther from our reach. What is more easily forgotten is that reduced consumption, as well as the corporation tax, will ultimately impair desires to invest. For in the long run investment depends upon a market for goods produced, and taxes which reduce consumption are bound to contract that market. If business men cannot sell, they will not need the enlarged plants and additional equipment into which it is hoped corporations and investors will pour their surplus funds.

3. *The "Double Taxation" Indictment*

The critics of our corporate tax system have been far from inarticulate in recent years. One of their loudest complaints is lodged against the so-called "double tax" on dividend income. The first tax is on the corporation, reducing profits available for dividends. The second tax is on the stockholder in the form of the individual tax upon the dividends he receives. While the "double taxation" indictment is principally leveled at distributed profits, it is also aimed at undistributed profits to the extent that they are reflected in the capital gains of stockholders who sell their stock. However, on the latter count the complaint is less bitter because of the relatively low rate of the capital gains tax.

More specifically, the "double tax" is said to be unfair because it results in a heavier tax on dividend income than on other income. The comparison between dividend income and interest income is particularly obnoxious. In computing its taxable income a corporation can

deduct the interest it pays to its creditors, but it cannot deduct the dividends it pays to its stockholders. However, the difference between interest paid on corporate indebtedness and dividends paid on corporate stock is often more illusory than real. To the bondholder interest payments are annual recompense for capital provided to the corporation. To the stockholder dividend payments are the same thing. It is true that the capital has been provided in slightly different ways. But frequently the courts have trouble deciding which way is which; indeed, upon occasion interest and dividends are as indistinguishable as Tweedledum and Tweedledee. Nevertheless, there is a great difference between interest and dividends to the corporation (and ultimately to its stockholders). In the one case there are two taxes; in the other there is only one.

Suppose, for example, that a corporation has $200,000 worth of assets, equally divided between "equity capital" from stockholders and "borrowed capital" from bondholders. If the interest rate paid is 5 percent, the corporation would be allowed a $5,000 interest deduction on the $100,000 of borrowed capital. If the corporation realized a 7-percent return on the total investment of $200,000, it would have a profit before interest of $14,000. With a $5,000 interest deduction, it would be taxed on only $9,000. But if the corporation were entirely financed with equity capital there would be no tax deduction for interest paid. The corporation would be taxed on the entire $14,000. By issuing $100,000 worth of bonds, instead of stock, it would cut its taxes about one-third.

It is strenuously argued that this differential puts an extravagant premium on debt financing. While the advantages of this premium may sometimes be exaggerated, there is little doubt that it effects a distortion of the capital structure of many corporations. Stockholders cannot foreclose, if dividends are not paid. But debt commitments require that fixed interest charges must be paid to bondholders. Undoubtedly the rigidity of debt contracts increases risks. To the extent that debt financing is encouraged and equity financing discouraged, the resulting corporate capital structure may be too flimsy to withstand the stresses of bad times.

On the other hand, preferences for borrowed capital may be actuated by powerful business, as well as tax, considerations. Capital is secured at low cost and dilution of the control of the management-

ownership group is avoided. Furthermore, if the prospects for profits are bright, a large return is possible with a smaller initial equity investment. It is a question worth much further investigation whether in recent years reliance on bond financing has not been encouraged less by tax motives than by low interest rates and the control of an increasing share of investment funds by insurance companies and other institutions compelled by law and custom to favor investment in bonds.

The "double taxation" indictment contains still other counts. It is said to make financing more difficult. There are two facets to this argument. The corporation tax may reduce the savings available for investment by corporations in plant and equipment, or it may reduce profits available for investment and thereby deter individual investors from purchasing stocks. How significant the reduction of funds is to corporate investment has never been established. Whether any great number of people are discouraged by the corporation tax from making investments, or whether their reaction is economically important is hard to determine, since it is entirely possible that individuals may from time to time change their standards for a reasonable return on investments. Quantitatively, the individual reaction seems to be unimportant, since individual savings habits are such that it is unlikely for some time that there will be any general shortage of savings in relation to the demand for investment funds. In specific instances, however, taxes may reduce the availability of funds and depress investment.

"Double taxation" is also denounced as having an adverse effect upon the revenue because it puts a premium upon the retention of profits in corporations. In no other way can the so-called "double tax" be avoided, or minimized or postponed. Avoidance of the personal income tax is complete if stock is held until death. The tax is minimized and postponed where dividend funds are held for distribution to stockholders in their low income years, and where dividend funds are allowed to accumulate for a period and then are finally realized by the stockholder in the shape of a profit on a sale of stock rather than by virtue of a dividend distribution. Taxes are therefore said to exert an inordinate influence upon corporate policy.

Implicit in these counts in the indictment against "double taxation" is the assumption that the corporation tax is not shifted to wage earners and consumers. If the final burden of the corporation tax falls on wage earners and consumers, the grounds for these complaints disappear.

There is then no "double taxation" because one of the two taxes imposed upon dividend income—the tax supposed to be paid by the corporation—is actually passed on to others. In this situation the corporation tax might be guilty on a charge of reducing consumption by raising prices and depressing wages, but it would be exonerated from the charges of inequity and discrimination against dividend recipients.

"Double taxation" is an elusive concept which calls for careful scrutiny. The premise of the criticism implied in the term is that corporation and stockholders are one economic entity. The distinction between corporation and stockholders becomes no more than a legal formality, a fiction which the law recognizes only for limited purposes. On the basic economic level, according to this theory, the corporation is no more than an aggregation of individual stockholders, a variety of partnership, a species of joint venture in quest of profits for its members. From this viewpoint one critic has described corporations as nothing more than "words on a piece of paper."

Of course this definition does not hold good on a strictly legal level. "It leads nowhere," as Mr. Justice Holmes has said, "to call a corporation a fiction. If it is a fiction, it is a fiction created by law with intent that it should be acted upon as if true."[1] The Supreme Court upheld the Federal corporation tax of 1909 as an excise upon the privilege of doing business in a corporate capacity. Moreover, taxpayers are quick enough to insist upon the separateness of corporation and stockholder, when that doctrine permits tax avoidance or is otherwise advantageous to them. Corporation and stockholder are one when separateness hurts; they are two when separateness pays. Nor should it be forgotten that at several points our tax system favors corporations as compared with unincorporated business. Such factors as relative corporate and individual income tax rates, stockholders' income, and how much and how long profits are retained enter into the complicated question of whether one form of doing business or the other gets the better break in a particular case.

From the legal and constitutional standpoints the taxation of corporations as separate entities is completely justified. Corporations are creatures of the law, owing all their privileges and advantages to public grant. It is true that corporate charters are issued by the states rather than the Federal Government, but the Supreme Court has decided that

[1] Klein *v.* Board of Tax Supervisors, 282 U. S. 19, 24 (1930).

this does not preclude the imposition of a Federal tax. Nor is it relevant at this point to insist that incorporation is open to everyone on relatively easy terms. Privileges granted by the state should be open to all citizens; the terms of the grant need bear no relation to economic value as long as there is no discrimination. Furthermore, while the grant of powers to corporations may very well be in the public interest, it does not legally follow that no tax price should be charged for the privilege of doing business as a corporation. The question here is one of policy, not of law. As a matter of legal history, "double taxation" is no novelty in the United States; in fact, it is inevitable in a diversified tax system. A real estate owner pays both a real estate tax and an income tax out of the income the real estate earns. In sales tax states both sales and income taxes are paid out of the same income. "Double taxation," if it hits all alike, can be perfectly equitable. It is not a crime *per se*. The Constitution as Mr. Justice Holmes has observed no more forbids double taxation than it forbids doubling the amount of a tax."

From the policy standpoint a corporation has many characteristics that distinguish it from the individuals for whom it is supposed to act. It gives limited liability to stockholders; they are not responsible for its debts as are the partners of a partnership. It has perpetual life and operative continuity as compared with the limited life span of an individual or a partnership. Its entity permits easy transfer of ownership and management. It has access to nationwide, sometimes world-wide, sources of financing which are not available to other forms of enterprise. Its structure permits intercorporate affiliation with or without integration of management. Finally, individual stockholders may have little practical control over either the day-to-day operations or the major policies, including the dividend policies, of many corporations. They have inchoate ownership of the corporate assets and earnings, but that is quite different from the direct type of ownership enjoyed by partners. These special characteristics of corporations are integral parts of modern big business operation; whatever their origin as legal fiction, they have become economic reality protected by law.

The problem of "double taxation" has to be even more fundamentally considered. It is necessary to inquire into the impact of the corporation tax upon stockholders in terms of the prices they have paid for their stock. Buyers are generally willing to pay an amount that will give them a return on their stock, after allowing for taxes, that is comparable

to the return they might receive on other investments. In purchasing securities they have bargained for an expected return after corporation taxes, and have paid accordingly. If the "double tax" were wholly, or even partially, eliminated, many stockholders would receive a windfall in the shape of larger dividends and higher market values for their securities than they had expected when they bought their stocks.

The cliché argument that the corporation tax "destroys incentive" and "kills the desire to take risks" also stands in need of candid re-examination. Certain critics charge that new investment in plant and equipment will not be made unless the prospective return is sufficient to offset the fear of loss of principal invested and to indicate a minimum return on the principal. It seems almost axiomatic that businessmen would be more inclined to go into perilous ventures if they could keep more when they won. But some businessmen might reduce their risk-taking if they could make a satisfactory profit without risk. Others would not be satisfied with any particular amount of profit and would go on being venturesome. The temperament of each businessman would determine his reaction. Higher rates of profit would embolden some, but not others.

There is another chapter in this story—the fact that through taxes the government shares in business losses, both corporate and individual. There would be discrimination against risky investments, if we had no provisions for offsetting losses. The income tax on the investor makes the Treasury his partner. While the Treasury always shares in gains, it does not share completely in losses, since the provisions for loss offset are limited. If they were complete, and part of the investor's loss were always absorbed in a reduced tax bill, the investor's risk would be commensurately reduced and risk-taking would not become less attractive. However, the reduction in income because of the tax might induce the investor to take more risks.

The principal present limitation on loss offset lies in the provision that losses may be offset only against income of the two years preceding or succeeding the loss. In appraising loss offsets we must take into account the fact that small corporations experience greater fluctuations in income than large corporations. Large corporations are more certain to have a steady flow of income over the years and are therefore in a better position to absorb their losses by applying them against the income of other years.

A generous allowance for the offset of losses reduces this discrimination between large and small corporations. The question then is: What kind of loss offsets are most beneficial to the economy? The carry-backs, which permit losses to be applied against the income of the two years preceding the year in which the loss occurs, help to keep dying firms alive and give a greater certainty of loss offset to old corporations with past net income than to new corporations with no past net income. Inequities of this type increase economic concentration and tend to lower the volume of new investment. If we want to increase the volume of new investment, we must give every possible impetus to new firms. A large part of the answer to the problem of increased risk-taking may, therefore, be in an improved method of loss offset. Here improvement lies in eliminating the net loss carry-backs—which were originally designed to provide a general method of offsetting tardily accruing reconversion costs against *wartime* income—and substituting a longer carry-forward.

An improved method of loss offset cannot alone solve the problem of diminished incentive. Even an unlimited carry-over provision would not insure full loss offsets for corporations which never realized income equal to their unsuccessful investments. Moreover, there should be restraints upon the encouragement given by tax law to concerns which have proved by extended experience that they cannot operate successfully. In any event, we need not rush desperately to the conclusion that the corporation tax should be abolished because it limits investment to some unascertainable degree. We do not abolish a tax solely because it imposes the measure of regulation and economic restriction involved in all taxes. We should rather attempt to eliminate defects and reduce economic restrictions to a minimum. By this approach we may gain the benefit of taxes without avoidable harmful effects.

4. *Is the Corporation Tax Regressive?*

Another charge frequently preferred against the corporation tax is that it is regressive and violates the principle of ability to pay. This is a serious criticism of a tax system which takes pride in relying upon the principle of progression. It is directed to the impact of the tax upon common stockholders, and it is made regardless of whether the tax is

shifted to consumers and wage earners. If the tax is shifted, it is clearly regressive. If it is not shifted, analysis is more difficult.

It is true that the corporation tax takes no account of the differences in income of stockholders. In the sense of its original impact it falls as heavily on widows and orphans as on multimillionaires. But, in effect, stockholders "deduct" the corporation tax in computing their individual income taxes, since the tax paid by the corporation reduces profits available for distribution and is not included in the individual income tax base. In evaluating the final effect of the corporation tax we must remember that many stockholders are subject to the progressive individual income tax, while some stockholders are protected from this tax by personal exemptions. From this viewpoint the small stockholder, who pays no individual income tax, bears the greater burden of the corporation tax, since the "deduction" of the corporation tax saves none of his taxes. On the other hand, the high bracket stockholder suffers very little reduction in dividend income because in any event his personal taxes would have taken most of his dividend distribution.

But the issue is not as clear-cut as this analysis makes it appear. The wide distribution of stockholdings does not prove that the tax is unfair to low income groups. In this connection the corporation tax critics mention such examples as the General Electric Company with 235,000 stockholders, the General Motors Corporation with 423,000 stockholders and the American Telephone and Telegraph Company with more than 650,000 stockholders. Of course, no one knows how many names are duplicated on various stockholder lists. But these figures do show wide distribution. They tell nothing, however, about the importance of dividends in relation to total income in different income classes. Dividends constitute a much larger proportion of high than of low incomes. In 1942, for example, dividends amounted to less than 2½ percent of the income of individuals with incomes of $4,000 or less and nearly 54 percent of the income of individuals with incomes of $200,000 and over. While the corporation tax taken by itself tends to be regressive because its burden is smaller per dollar of dividend income, the higher the dividend recipient's income bracket, this regressive tendency is offset because the percent of income upon which the tax is imposed increases as income increases. A tax which reduces dividends representing such a large percent of income of high bracket taxpayers cannot be said to have a wholly regressive effect.

Looked at in another way, the net burden of the corporation tax on profits distributed as dividends could be replaced by increases in the individual income tax. It could be replaced not in the sense that the increases would fall upon exactly the same individuals, but rather in the sense that the same net amount of taxes could be levied on each taxable income class. With a set of individual rates somewhat lower than present rates and roughly the present dividend distribution by income classes, the replacement would require additional surtaxes ranging from about 2 percent on incomes of less than $2,000 to about 7 percent on incomes over $8,000. This indicates that even though the corporation tax takes more per dollar of dividend income in the low income brackets than in the high, the slight importance of dividend income to low income individuals, as compared with its major importance to high income individuals, is a factor that makes for a broadly progressive tax. The moral is plain. If the corporation tax is not shifted, it is less burdensome to consumption than many other taxes. It is, however, likely to be less progressive than the individual income tax.

5. *Undistributed Corporate Profits*

Almost everyone agrees that the present tax treatment of corporate income is unsatisfactory. Theoretically, there is no good reason for taxing income at the business level, if it may be taxed as equitably after it is received by the individual owners of the business. But there are two practical reasons why outright repeal of the corporation tax in favor of increased reliance upon the individual income tax is not feasible. First, *all* corporation profits cannot be taxed when received as personal income by the shareholder, since a substantial part of corporation income remains, at least temporarily, with the corporation and is not paid out in dividends. If we abolished the corporation tax and made no provision for taxing undistributed corporate profits, corporations would be able to accumulate tax-free profits indefinitely. Stockholders could realize cash by occasional sales of stock, and gains on these sales would be given preferential capital gains treatment. The stock not sold during life could be passed on to heirs without the payment of any income tax. The estate tax would eventually reduce the amount of untaxed profits, but there would be left a substantial amount of transmitted wealth upon which income taxes had been avoided. Furthermore, if the corpo-

ration tax were eliminated and no provision were made for taxing accumulated corporate profits, unincorporated business would be almost helpless in the face of the discrimination in favor of incorporated business. Stockholders as individuals would be completely favored over individuals who owned no stock. Persons owning stock at the time the tax was repealed would have enormous windfall gains.

The second reason for retaining the corporation tax in some form in our revenue system is that it would hardly be expedient to meet practically all of our revenue requirements from the individual income tax. From the standpoint of our economic goals of high employment and high national income, a corporation tax is distinctly preferable to increased reliance upon excise taxes. With a fixed revenue goal the tax escaped by corporations on their savings would have to be recovered from somewhere; without doubt a large share of the burden would fall more heavily on consumption.

It should be noted in passing that the Treasury has been consistently unsuccessful under existing law in dealing with the problem of preventing tax avoidance by the accumulation of profits in corporations. The penalty tax upon personal holding companies touches only a small segment of the problem. There is little compulsion toward distribution in the provision of the Internal Revenue Code designed to prevent the avoidance of surtax by the unreasonable accumulation of corporate profits. The rate of tax imposed (27½ percent on the first $100,000 of undistributed net income and 38½ percent on undistributed net income over $100,000) is not sufficient to require distribution of corporate profits where the stockholders are in the high individual income tax brackets. Some corporations deliberately run the penalty risk on this cold-blooded basis.

The magnitude of this problem may be deduced from the simple fact that in 1945, out of total net profits after taxes and renegotiation of nearly $9,000,000,000, corporations with net income failed to distribute about $4,300,000,000. This amount was retained in surplus either because the personal tax would be too high if the profits were distributed or because the funds were thought to be needed in the corporate business. Besides indicating that there is not a sufficient distribution-compelling influence in existing law, these accumulations suggest that there will be many reasons in terms of the postwar economy for not distributing profits. It will be an unimaginative corporate executive who can-

not find plausible business reasons for large accumulations of surplus in the days to come. There remain, as always, the rainy day of the unpredictable future and another kind of day when taxpayers may go into a new business in the manner of the White Knight, who kept a beehive on his horse because he might someday wish to keep bees.

6. *Methods of Co-ordinating Individual and Corporation Taxes*

Four basic methods have been suggested for diminishing or eliminating "double taxation" on dividend income. The first method would not tax the corporation, but would tax corporate profits as if the stockholders were partners, and perhaps even allow stockholders to treat corporate losses as their own. This technique has been employed in the past in a limited way; it was applied to personal service corporations for all purposes in World War I, and it was made optional for personal service corporations for excess-profits tax purposes in World War II. The second method would leave a tax on corporate profits, but would allow a reduction in that tax for dividends paid; in net effect this plan would impose a corporation tax only upon undistributed profits. The third method would tax all corporate profits and adjust the individual tax of stockholders to take account of the tax paid by the corporation. The fourth method would eliminate the corporation tax and tax stockholders on realized capital gains at regular individual rates.

The Partnership Method

The partnership approach adopts and acts upon the theory of the "double taxation" critics that there is no economic difference between a corporation and its stockholders. Corporation income would be taxed directly to the stockholders according to their holdings of stock, whether or not the income was distributed in dividends. Income from corporate activity would thus be taxed only once. Corporate managers would not have to worry about the corporation tax. There would be no corporation tax, and the desire to invest would be uninhibited. Of course there is some doubt as to the constitutionality of taxing stockholders on income they have not received. There are also a number of technical and administrative difficulties involved in applying this method

to large corporations with many stockholders. The plan would work best with closely held corporations with simple capital structures and comparatively few shareholders.

The most serious technical and administrative problems of the partnership method spring from the necessity of apportioning profits among stockholders. These difficulties arise because of the tremendous number of shareholders owning stock in many corporations and also because of the frequent changes of stock ownership throughout the year. It would probably be necessary to allocate undistributed profits as of some fixed date—perhaps the end of the corporation's fiscal year. These problems are great for very large corporations which, while numerically few, realize the major portion of aggregate corporate profits. There would be further complications when retained earnings were divided among classes of stockholders. Profits allocated in one year to common stockholders might be used in a subsequent year to pay dividends on preferred stock; to correct this situation returns for all common stockholders of the earlier year would have to be reopened.

Many compromises with the strict partnership principle would be necessary, if this method were adopted. Complete fidelity to the principle would require the reopening of stockholders' returns for previous years whenever audit or court decision resulted in changes. Perhaps it would be feasible to limit reopening to major revisions, and to make minor corrections in the current year. A compromise might also be adopted to deal with such items as partially tax-exempt income, capital gains, charitable contributions and income and profits taxes paid to foreign governments. Without some departure from the partnership principle these items would have to be reported separately to stockholders and treated as if they had accrued directly to them.

On equity grounds the partnership method presents another critical drawback. While all stockholders would be taxed at their own individual rates, some minority stockholders might have no outside means of paying the tax on undistributed profits. Even if their stock increased in value in direct relation to the accumulated but undistributed profits, which is hardly ever the case, they would have to sell some of their holdings to pay the tax on their share of retained earnings, if they had no other means of paying the tax.

Against these disadvantages, certain advantages of the partnership method should be weighed. If the corporation tax were eliminated,

any pressure by management to shift the tax to consumers and wage earners would be lifted; a possible deterrent to investment would be lessened; and the existing premium on debt financing would be removed. Purchases of stock might be stimulated and outside financing facilitated; inside financing would become easier for many corporations without access to national capital markets. Moreover, the tax relief per dollar of dividend income would be greater the lower the taxpayer's income bracket.

Some of the difficulties inherent in the partnership method—particularly those deriving from the financial load put upon stockholders—could be avoided if the tax upon stockholders were collected from the corporation rather than from the individual stockholders. A circumscribed application of this technique has been tried in the United Kingdom and Australia. Under this variation the taxed distributions would be free from the individual income tax, if and when they were later distributed. While this system would be easier upon stockholders, the administrative problems of dividing undistributed profits and calculating the individual tax for each stockholder upon his share, as if it had been distributed, would remain. Furthermore, collection of the tax from the corporation would probably to some degree affect investment decisions, and possibly price and wage policies.

To the extent of its practicability, partnership treatment could be made either optional or mandatory. If the method were optional, it would fail to prevent tax avoidance by retention of profits in the corporation, but it would afford relief from "double taxation," and a means of avoiding possible constitutional obstacles. An optional system also raises the complicated question whether the exercise of the option should be binding for future years or should be open to a new exercise each year.

If the method were mandatory, it would help to prevent the use of the corporation as an instrument for postponing or avoiding the personal tax on dividend income. However, mandatory treatment might work great hardship upon the stockholders of small corporations, while discriminating in favor of the stockholders of large corporations to which the method could not readily be applied. Mandatory treatment would be too drastic if its net effect were to subject the stockholders of small corporations to high surtaxes upon all the income of their corporations, while the stockholders of large corporations paid surtaxes only

upon distributed corporate income and at the same time undistributed income was subject only to a 38-percent corporation tax.

Dividend Credit at the Corporate Level

The essence of the second method of co-ordinating individual and corporation taxes is to impose an income tax upon the corporation, but to grant a full or partial deduction or tax credit to the corporation for dividends paid out. If full credit were given to the corporation for dividends paid, "double taxation" on distributed profits would be completely eliminated; dividend income would be relieved of the corporation tax and subject only to the individual income tax. This method could, of course, be refined to allow for any desired corporation tax upon distributed earnings by limiting the deduction or tax credit for dividends paid. The theory of the plan is akin to the theory underlying the provision of the Revenue Act of 1942 which allows a credit against surtax net income for dividends paid by public utility companies on preferred stock issued prior to October 1, 1942.

Aside from solving the "double taxation" problem, this approach has other points in its favor. It would generally protect the revenue from tax avoidance by profit accumulations in corporations. If full credit were given for dividends paid, the premium on the use of borrowed capital would be canceled. Since the tax would be reduced on all corporations except those which distributed none of their profits, management would have greater freedom in making investment decisions and would be less inclined to shift any part of the tax to wage earners and consumers. Insofar as tax reduction led to larger dividend payments, individuals would be encouraged to invest in stocks.

One flaw in this method lies in the unequal taxation of distributed and undistributed profits. The corporation tax would never be exactly the same on some parts of undistributed profits as the combined individual and corporation tax would be if the profits were distributed. But a greater defect in the plan issues from the fact that many small and medium-sized corporations, without ready access to capital markets, must retain earnings in order to expand. A corporation tax which offered an inducement to distribute earnings might play into the hands of large, developed corporations in a position to distribute all or most of their profits to shareholders. Some modification which recognized the

problems of financing small and medium-sized business would certainly be necessary.

One way to place small and growing corporations in a better financial position would be to consider a certain amount of retained earnings distributed for tax purposes and exempt that amount from the tax. However, this technique has certain drawbacks, not the least of which are that corporations might be unduly encouraged to retain profits and individuals would be able to postpone some of their personal tax. And, like most relief provisions, this refinement would introduce complications. It would have to be decided whether relief should be extended, regardless of the amount of income or the amount of dividends paid, or whether only a stated amount of income available for dividends should be treated as distributed, and no relief allowed if the dividends exceeded this amount. Some procedures would have to be developed to limit the size of the allowance and to permit an extensive carry-over period so that retention of earnings in one year might be offset against distributions in excess of earnings in another year. Moreover, special types of income, such as intercorporate dividends and nontaxable income, would call for special treatment. However, these problems are solvable, and do not condemn the method, if it is otherwise acceptable.

Mr. Ruml and Mr. H. Christian Sonne, in their postwar tax plan, have adopted the theory of adjusting the corporation tax for dividends paid. They would virtually eliminate the corporation tax on distributed profits and tax shareholders only once on dividend income. Recognizing that there is some value to doing business in the corporate form, they suggest a small franchise tax of 5 percent on corporations as a price of that privilege. To solve the problem of undistributed profits they would impose an additional tax of 16 percent on that part of corporate income—after franchise tax—which is not distributed. (This rate assumes that 16 percent will be the lowest postwar individual income tax rate.) Thus retained corporate income would be taxed at the minimum rate applicable to other income subject to individual income tax. The undistributed profits tax might or might not be credited to individual stockholders, if and when retained income were subsequently distributed as dividends.

Mr. Sonne has proposed an amendment to the plan designed to mitigate the financing problems of small business. He would place an even

greater burden upon undistributed earnings by making withheld earnings in excess of one-quarter of the total, or in excess of $50,000, whichever is the larger, "subject to a very high surtax—for instance 60 percent (meaning altogether 16 percent and 60 percent)—so that for all practical purposes large businesses would have to pay out at least 75 percent of their earnings while small businesses would be helped by being able to add $50,000 to their surplus."

Dividend Credit at Individual Level

The third method of co-ordinating individual and corporation taxes would make an adjustment for the corporation tax on distributed profits at the individual, rather than the corporate, level. This could be done in three ways: first, by imposing a tax on all corporate profits and treating part or all of it as a withholding tax when dividends were distributed; second, by exempting dividends from a substantial individual normal or first bracket tax rate; or, third, by excluding part of dividends received from the taxable income of stockholders.

Withholding

Under the withholding plan individuals would include in their taxable incomes cash dividends received plus the withholding tax paid by the corporation. After computing their individual income tax, stockholders would take credit for the tax withheld by the corporation. The theory is that a tax paid by the corporation may be regarded as a tax paid by, or on behalf of, its stockholders. This is the system used in Great Britain. It would be similar to our present withholding system for salaries and wages.

The withholding technique raises a number of problems. The choice of a withholding rate is particularly difficult. If the rate were equal to the minimum individual income tax rate, there would be considerable postponement of individual tax, since most dividends received by individuals are subject to a higher than minimum rate of tax. If, in order to prevent avoidance and postponement of tax, the withholding rate were as high as the rate in the highest individual tax bracket, it would doubtless be too severe. To protect the revenue from tax avoidance by the retention of earnings in corporations, the withholding rate would have to be as high as the average individual rate on dividend in-

come. Furthermore, some provision would have to be made for refunds when overwithholding occurred.

The simplest way to use withholding would be to require stockholders to add to their cash dividends for tax purposes a uniform amount to cover the part of the corporation tax considered withheld. If, for example, the entire 38-percent corporation tax were considered as withholding, the stockholder would include in his taxable income approximately $1.61 for each dollar of dividends he received. (A dollar of dividends in cash would equal $1.61 of dividends before withholding tax of 38 percent, since 38 percent of $1.61 equals 61 cents.) After computing his individual tax liability, the stockholder would then apply the 61 cents as a credit.

Such simplicity has disadvantages. In the absence of specific legislation requiring corporations to reduce contractual dividends on preferred stock by the amount of the withholding tax, preferred stock dividends would not be reduced by the withholding tax collected from corporations. If preferred stockholders were allowed the same tax credit as common stockholders, they would receive a windfall since, in effect, they would be credited with taxes the common stockholders paid. Moreover, there is no way of making sure in all cases that the simplest version of withholding would result in an accurate statement of actual withholding on the profits from which dividends were paid. But more serious problems would arise in connection with dividends paid from earnings and profits accumulated prior to the adoption of the plan, from wholly tax-exempt interest, and from profits of prior years when different rates of withholding were in effect.

Some of these difficulties could be obviated by a method which allocated withholding in a more precise way to particular dividend payments. Corporations could be required to report to each stockholder and the Bureau of Internal Revenue the exact amount withheld on dividends paid. Stockholders would then use this statement in making their returns; they would add the tax reported as withheld to the cash dividends received and use as a credit the tax reported as withheld. When dividends were paid, the corporation would allocate the tax withheld between distributed and undistributed profits. If the dividends exceeded the current year's income, it would be assumed that the excess came from the most recently accumulated profits of previous years. Exempt income or income subject to tax at less than the standard

corporate rate could be prorated between dividends and undistributed income, or it could be assumed that payments came first from nontaxable income of prior years, and from taxable income only after nontaxable income was exhausted. This more refined method of withholding would present some serious administrative problems.

Objection has been raised to withholding on the ground that it discriminates against capital gains. This criticism points out that capital gains at least in part stem from undistributed profits. A stockholder may realize his share of undistributed profits either by receiving a dividend or by selling his stock at a gain. Under the withholding method he would get a tax credit if he received a dividend, but no credit if he realized a capital gain.

It is doubtful that this discrimination is so serious as to cause much concern. Withholding on undistributed profits would tend to mean higher prices for stocks since purchasers would, in effect, receive a tax receipt for withholding, redeemable when the profits were paid out in dividends. If investors expected that retained profits would be paid out soon, stock prices might include practically the full amount of withholding. In these circumstances, sellers would get their share of withholding on retained profits as part of their capital gains. In cases where the market value of stock did not reflect the full amount of withholding, sellers would not get full benefit; this would be true in cases in which it was expected that retained earnings would not be paid out for several years. But any discrimination against capital gains would largely be offset by the comparatively low rate of the capital gains tax. The discrimination would, of course, be more serious if the differential capital gains rate were eliminated, and capital gains were taxed as ordinary income.

On the credit side of the ledger the withholding approach could completely eliminate "double taxation." At the same time it would keep a tax on undistributed profits and thereby minimize individual tax postponement or avoidance. It would encourage individuals to invest in stocks, since they would be assured of a larger return on their investment after taxes.

On the debit side, withholding would not completely equalize taxation of distributed and undistributed profits, since the withholding rate on undistributed profits would be lower than the marginal rate of some stockholders and higher than the marginal rate of others. Moreover,

the method would tend to strengthen the competitive position of large, rather than small, firms. As opposed to the dividend credit at the corporate level, it would be impossible under the withholding approach to exempt a portion of undistributed profits from tax without allocating withholding precisely between distributed and undistributed profits. Dividends paid from partially or wholly tax-exempt corporate income, dividends on preferred stock, and capital gains would present the same problem, which could be solved only by requiring corporations to adopt the exact reporting method. Withholding has the added disadvantage of failing to eliminate the corporation tax as a factor in management decisions. Furthermore, internal financing would be no easier under withholding than under the present corporation tax.

The Committee for Economic Development is one of the principal exponents of the withholding approach. It would tax corporate income, whether retained or distributed, at a rate equal to the first bracket rate under the individual income tax, assumed to be 18 percent, and credit the individual stockholder with the corporation tax which had been paid out in his behalf. All dividend income to stockholders would, of course, still be subject to surtaxes. Individuals would calculate dividend income for surtax purposes by adding the amount of tax paid by the corporation to the amount actually received as dividends; those who were unable to apply their full personal exemptions against other income would be entitled to tax refunds.

The Committee for Economic Development suggests, however, that only by changing the capital gains provisions can a satisfactory solution for taxing undistributed profits be reached. It proposes that ultimately capital gains and losses should be treated like other income, that is, gains would be taxed at ordinary rates and losses would be fully deductible. It advocates this change when corporation and personal income taxes have been substantially reduced and the averaging of income over a period of years is permitted. At present, like the Ruml-Sonne plan, the Committee for Economic Development would retain the differential treatment in favor of distributed corporate earnings.

Credit for Dividends Received

The second method suggested for co-ordinating individual and corporation taxes at the individual level would allow stockholders a credit

or exemption for dividends received. The approach is similar to the method used in this country prior to 1936. Advocates of this plan usually contemplate a corporation tax rate equal to the individual normal tax or first bracket rate. Dividends would be exempt from a normal tax, or from the first bracket of the individual tax; or stockholders would be granted an equivalent credit. The dividends would then be subject to individual surtax rates, or rates in excess of the first bracket rate. While a number of refinements may be introduced in applying this technique, basically the method is concerned with reducing the tax burden on the individual investor.

In some respects this method treats the corporation tax as a withholding tax on dividends distributed to stockholders. But there is a vast difference between this type of withholding and the withholding currently in effect on wages and salaries. For under this plan stockholders would not include in their taxable incomes the portion of their dividends withheld by the corporation. The result is much the same as if wage and salary earners did not have to pay tax on that portion of their income withheld by their employers.

One objection to this approach stems from the assumption that the corporation tax rate and the starting individual rate should be the same. There is little practical or theoretical reason for any such equality. Furthermore, if no discrepancy in rates were permitted, the possibility of adjusting either corporate or individual rates to revenue needs or changing economic conditions would be greatly diminished.

However, this plan is vulnerable to the graver charge that it is heavily weighted in favor of high income stockholders; low income stockholders would come out at the short end of the economic stick. It gives too much relief to stockholders in high individual income brackets and too little relief to stockholders with incomes below the personal exemption level, who may be overtaxed under the present system even though they do not pay a second tax on their dividends. The stockholder with no individual tax to pay receives no benefit at all under the plan; he is taxed just as heavily as the stockholder subject to the individual income tax at the normal tax or first bracket rate. But the stockholder in the high surtax brackets might pay less combined corporation and individual tax on distributed corporate income than he would if he received the income from unincorporated business, or than he would pay in individual income tax alone if there were no corporation tax at all.

This situation arises because the corporation has already paid part of the tax on his dividend income for him. For example, if a corporation pays a 20-percent tax, or $20, on $100 of profits and distributes the remaining $80 to a stockholder with a 70-percent individual rate, the stockholder's tax on the dividend is 70 percent minus 20 percent, or 50 percent. He is credited with the 20-percent tax the corporation has paid which, presumably, is also the basic individual rate. The individual tax on the dividend is 50 percent of $80, or $40; the corporation tax is $20, making a total of $60. If there were no corporation tax, the stockholder would pay a 70-percent individual tax on $100 of distributed corporate profits, or $70. In this instance "double taxation" has been overeleminated by $10. The higher the individual rate, the greater the overelimination would be.

The exemption of dividends received from part of the individual income tax would, then, more than eliminate "double taxation" of dividends received by the highest bracket stockholders. In the lower brackets distributed profits would still bear a higher tax than other income. The corporation tax would still be a factor in management decisions. But there is no doubt that the plan would give high bracket taxpayers an enormous incentive to invest in stocks.

The Committee on Postwar Tax Policy recommends this method of co-ordinating individual and corporation income taxes. It would tax corporation income and individual income at the same initial rate, with a provision for offsetting the tax on dividend income in computing the individual income tax. Individuals would receive credit at the initial rate (corresponding to the traditional normal tax) for the tax paid by the corporation on the income distributed.

This committee's solution of the difficult problem of retained earnings is to disregard it; it considers that the problem is not of great importance in the postwar period. On the other hand, the committee contends that it is of great importance that corporate management should be free to make decisions respecting accumulations. A harsh attitude toward the retention of earnings, the committee believes, will impair managerial freedom of choice as to the best procedure for business growth. It naïvely assumes that the Treasury may rely on the *bona fides* of managerial decisions relative to the proportion of earnings which the best interests of the respective enterprises require should be retained. The committee fails to recognize that under existing law

the penalty for nondistribution of earnings is much less severe than the penalty for distribution.

Dividend Exclusion Plan

A variant of the dividend credit at the individual level, favored by the Twin Cities group in their postwar tax plan, would exclude a portion of dividends received from individual taxable income as rough compensation for the corporation tax paid. The Twin Cities plan would impose a 40-percent tax on corporate profits. Individuals would be allowed to exclude 40 percent of dividends received in computing their taxable income. On their reduced dividend income they would then pay the individual income tax in full. Since the degree of compensation is much less for the small income stockholder than for the high bracket investor who receives a substantial amount of dividends, the result would be a weakening of the progressive rate scale for those whose incomes are largely from dividends. This method would go even farther in favoring high bracket stockholders than the straight plan of allowing a credit for dividends received.

The Twin Cities plan does not specifically refer to the problem of undistributed profits. But by advocating that the maximum capital gains rate be cut from 25 percent to 12½ percent, the plan would make even less effective the present inadequate substitute for taxation of undistributed profits, that is, the taxation of capital gains realized upon the sale of stock.

The Capital Gains Method

Another approach to the tax treatment of corporate profits would eliminate the corporation tax entirely and rely on capital gains taxation to prevent tax avoidance on undistributed profits. The underlying theory is that stockholders have realized taxable income only when they receive dividends or make a profitable transfer of their stock. Under this method a gain would be realized not only when a stock was sold, but also when it was transferred by gift or bequest. Gains realized at any of these times would be taxed at the regular individual income tax rates and not at a limited capital gain rate. If there were a loss instead of a gain, the loss would be fully deductible against other income.

Certainly, taxing capital gains at the same rates as other forms of income would at least partially offset the present tendency of stockholders to avoid taxes by trying to realize a return on their investments in the form of capital gains rather than dividends. To the extent that the accumulated corporate earnings were reflected in the market value of the corporation's stock, theoretically the method would result in the taxation of retained corporate profits. Unfortunately, however, accumulated corporate profits are only one of the many factors determining market value. Shifts in stock prices are largely due to revised estimates of future earnings and losses. While book value, which would reflect retained earnings, is accepted as evidence of market value and on occasion must be taken into account, it is generally an unreliable indication of market value, particularly where a corporation's accounting system is deficient. It is, therefore, obvious that this approach would leave some corporate profits untaxed. If economic conditions destroyed a corporation's prospects for future profits, the profits retained by the corporation in previous years would never be taxed. If the stock of a successful corporation were sold at a low price, when the stock market was temporarily depressed, the retained profits would not be taxed to the original stockholder, but rather to a subsequent stockholder who purchased the stock when the price was low. If future operations seemed extremely promising, the tax would fall on much more than retained earnings, since market values would reflect these prospective profits.

Even if perfect co-ordination existed between market values and retained earnings and all undistributed profits were ultimately subject to tax, the capital gains approach would usually put at the stockholder's option the period in which the profits were taxed. He could sell in the year which was most favorable to the rest of his tax picture, or not at all. He would be in a position to postpone the tax at least until a moment of generosity overcame him, or until his death. In the meantime, he might have enjoyed the economic power and prestige that goes with the ownership of stock in a growing corporation, without receiving any large dividend payments or realizing any capital gain. If, in the end, the value of the stock disappeared, he would escape taxation on the income from which he derived his advantages, and the retained earnings would never be taxed to the corporation.

Not the least of the faults of the capital gains method is the discrimi-

nation which would result between stockholders and the owners of unincorporated businesses. The latter must pay their taxes annually, whether or not their profits are withdrawn from the business, but the former would be taxed only when they withdrew profits in the form of dividends or disposed of their shares. It is doubtful that this discrimination could be avoided by offering unincorporated businesses the option of being treated in the same manner as corporations, that is, the option of not being taxed on retained profits.

While the capital gains approach would eliminate "double taxation," it would be an inadequate method of taxing undistributed corporate profits. To the extent that it failed to impose tax upon retained profits, either at the corporation level or in the hands of stockholders, the method would free from tax an important source of savings. It would discriminate among taxpayers, since the sources of corporate savings would not be taxed while the sources of other kinds of savings would continue to be taxed. With a set revenue goal some of the tax burden would have to be shifted. The available alternatives would, of course, be heavier taxes on consumption and on investment not financed out of retained corporate profits. It is likely that a resort to these alternatives would reduce our chances of maintaining a high level of employment and national income.

7. *Summary*

The years immediately ahead will be the time for decision on the corporate tax front. We must decide whether the corporation tax is to continue in our Federal tax system, and what kind of tax is to remain, if any remains at all.

Whether or not corporations are separate economic entities seems to me finally to resolve itself into a question of degree about which reasonable men may honestly differ. It is a question which cannot be answered categorically for all corporations. Economically speaking, many small, closely held corporations are nothing more than partnerships, and many large corporations with widespread ownership are much more than partnerships. In between are many hybrid corporations which are something more than partnerships and something less than economic entities distinct from their stockholders. The solution of the problem of taxing corporations and their stockholders on a ra-

necessarily decline and the market for manufactured products would correspondingly shrink. In the end we would be almost impossibly handicapped in achieving our goals of high production, employment and national income. Enlightened self-interest dictates that we choose our sources of revenue on the basis of minimum harm to the economy as a whole.

I would eliminate the corporation tax—or charge only a moderate franchise tax—for corporations which, in a predominant sense, may not be classified as economic entities distinct from their stockholders. In general, these would be small corporations with a limited number of stockholders. The corporation tax could be eliminated by granting these corporations and their stockholders the option of reporting as partnerships. This method of reporting could be made mandatory rather than optional, but in the absence of a stiff undistributed profits tax this would be harsh medicine for some small and new enterprises with prosperous stockholders. These businesses might need their profits for expansion and could not use them for that purpose by paying the regular corporate rate on undistributed profits. Corporations of this type might thus be put at a disadvantage as compared with larger corporations to which the partnership technique could not be applied. On the other hand, the optional method presents many technical difficulties which are a long way from being solved.

The partnership method would give complete relief from "double taxation" and wipe out the discrimination in favor of interest income. Where it was not applied—to large corporations with separate economic entity—I believe relief should be given by making a substantial differentiation in favor of corporate profits which are distributed as dividends. A differential in favor of distributed corporate earnings would partially offset the existing premium on the use of borrowed, rather than equity, capital.

It is not easy to decide what form this differential should take. It is much easier to state the form it should not take. I am unalterably opposed to the techniques proposed by the Committee on Postwar Tax Policy and the Twin Cities group. Both would concentrate relief in the high brackets. The plan of allowing a dividend credit at the corporate level, advocated by Mr. Ruml and Mr. Sonne, poses some difficulties; the withholding tax approach, advocated by the Committee for Economic Development, raises others. But both methods could be made

fair to low bracket stockholders. From the economic standpoint, these two methods would mitigate our oversaving problem, while the methods of granting a dividend credit at the individual level advocated by the Committee on Postwar Tax Policy and the Twin Cities group would, in addition to their other faults, intensify this problem.

To give maximum encouragement to risk capital, it may not be enough to provide a tax differential in favor of distributed corporate earnings. Although a differential would promote distribution and a substantial corporation tax on undistributed earnings would minimize the use of corporations as instruments to avoid taxes, inside financing might remain difficult. Getting corporate earnings distributed is not a complete solution to this complicated problem. In many cases it is much better for the corporation—and the economy—to retain earnings for use in the expansion of the corporate business and in new ventures.

One basic remedy for this condition is appealing, however forbidding the administrative obstacles may be. If we could allow some deduction for purposes of the tax on undistributed earnings—or the entire corporation tax if the differential in favor of distributed earnings takes the form of a credit to stockholders—for investment in *new* capital additions, new investment would be encouraged. If we resorted to this heroic remedy, no deduction should be allowed for the purchase of an *old* plant, but only for the construction of a *new* plant. We might also consider the Swedish plan of reducing taxes for enterprises that undertake construction during periods of business recession. These expedients come so close to being subsidies that I believe they should be adopted only if it is absolutely necessary to stimulate the expansion and increased production that are indispensable to a high level of income and employment.

The limited character of the loss provisions of tax law may be as much, if not more, responsible than high rates for business inertia. More generous loss offset provisions are a necessary step forward in the taxation of corporations and individual businesses. I believe the present carry-back provisions should be eliminated and the existing provision for a two-year carry-forward of net operating losses should be extended to at least five years. This change would substantially benefit small business where profits are subject to greater fluctuation, and are therefore less available for loss offset, than the profits of big business. With these amendments to the statute businessmen could strike out into

new territory with a greater sense of safety, for they could count on the government to share more fully in their bad, as well as their good, fortune.

Part of the problem of undistributed corporate earnings stems from the fact that, from the stockholder's viewpoint, these savings constitute untaxed capital gains. If a stockholder sells his stock, the undistributed profits are at least indirectly subject to capital gains taxation. But if the stockholder does not sell his stock, a potential capital gain escapes taxation. Although in many instances this gain will ultimately be subjected to *estate* tax, our tax structure should contain a provision to stop this serious *income* tax leak. I believe the most feasible technique would be a tax upon the gain—with perhaps a corresponding treatment of any loss—at the time of any gift of the stock, even to a charity, and at the time of death. A provision of this kind would capture the tax in the end, although somewhat tardily if no gift were made.

Chapter 40

ACCELERATED DEPRECIATION

Not long ago a prominent industrialist expressed a profound economic truth in a message to the management personnel of his company:

> Some have an idea that the reason we in this country discard things so readily is because we have so much. The facts are exactly the opposite—the reason we have so much is because we discard things so readily. We replace the old in return for something that will serve us better.

We live in an age of change, of scientific discovery, of technological improvement, that constantly makes possible more and better things for all of us. And it is partly because we have always been ready, even eager, to accept change that our standards of living have long been the envy of the rest of the civilized world.

This subject is by no means academic. It has definite and immediate application to taxation. Every day a factory or a machine or a piece of equipment operates, it is subjected to physical wear and tear which will finally cause it to lose its usefulness. Factories, machines and equipment are capital assets. The corporation tax is imposed upon income, not capital. If a tax upon capital is to be avoided, provision must be made for replacing capital assets when they are worn out, but there must be no tax upon the fund required to make replacement. The tax upon this fund is avoided by permitting the owner to deduct each year from gross profits a percentage of the cost of the assets until finally the total deductions equal the total cost. This is usually done by allowing the same percentage of the total cost to be deducted each year as the year bears to the assumed total life of the assets.

But physical wear and tear is far from being the whole story; ob-

solescence is also recognized by tax law as a permissible deduction. As technological developments occur, provision must be made for replacing plants and machines and equipment with better and more economical plants and machines and equipment, if business is to maintain the integrity of its investment, keep its properties modernized and provide continued employment and return to owners. A rising wage scale accentuates this problem. As a matter of fact, mounting wages stimulate the ingenuity of management to provide more efficient machinery. From the standpoint of labor, the obsolescence deduction is highly important since it helps management to provide the new machinery which raises the amount of output per worker and consequently enables the payment of higher wages.

Accelerated depreciation has been proposed as a measure to promote investment by allowing the taxpayer a speedier recovery of particular capital outlays. This proposal is not directed to an increase in the depreciation rate to accompany a more-than-normal rate of use and exhaustion of an asset, but rather to speeding up depreciation allowances on newly acquired assets regardless of the actual rate at which they are wearing out. It would allow taxpayers to write off capital assets in a shorter time than would be considered reasonable in computing income under any generally accepted accounting practice. In effect, it would enlarge the deduction for depreciation in the early years of the life of an asset and eliminate the deduction in the later years.

The advantages of accelerated depreciation, according to its advocates, are: (1) it would reduce the riskiness of investment and so encourage capital outlays that would not otherwise be made, thereby stimulating employment and business activity; (2) it would speed up replacement of plant and machinery, not merely when it was physically obsolete, but also when it was economically obsolete, thus promoting new and more economical processes; (3) in certain forms it would spread replacement and new investment more evenly over the different stages of the business cycle, and so help to minimize business fluctuations; and (4) it would stimulate investment by small and expanding firms and thereby improve the competitive structure.

Opponents have raised a number of objections to the allowance of accelerated depreciation. The American Institute of Accountants fears that high initial depreciation rates on new machinery might lead to

unnecessary abandonment of much useful equipment, cause unforeseen competitive advantages and "influence businessmen to undertake transactions with an eye to tax savings rather than sound economic policy." The institute holds that when costs properly attributable to a future year are permitted to be anticipated for tax purposes, taxable income is understated for the earlier year and overstated for the later year. If tax rates go down, the businessman will have enjoyed a subsidy at the expense of taxpayers in general; if they go up, he will have suffered a penalty. The institute believes that present disparities between taxable income and business income have brought about an undesirable condition which "will not be improved by introducing new subsidies or incentives into the tax system."

Professor Harold Groves, on the other hand, recommends more latitude in the timing of deductions for depreciation and obsolescence. He says:

> Shortening the write-off period for these impairments of capital promotes economic progress by reducing resistance to the purchase of improved equipment. Accelerated depreciation . . . could be used to promote investment during a depression, and, in extreme cases, its use for such purposes is recommended.

Some skepticism may be permitted about this recommendation. Like most tax inducements, this one would have its price. The price would be an actual long-run loss of revenue. Tax law allows for the deduction of losses on account of complete abandonment or retirement where equipment is not kept in reserve. But the privilege of deducting abandonment and retirement losses is of no value unless the taxpayer has sufficient income to absorb the deduction. Low depreciation rates may deter the acquisition of new facilities because of the uncertainty that income will be available throughout the depreciation period. Here again the carry-back and carry-forward provisions reduce the danger that full tax advantage may not be taken. However, the carry-backs have serious drawbacks as a permanent part of our tax system and the carry-forwards in their present limited form are less favorable to small, compared with large, corporations than longer carry-forwards would be.

Accelerated depreciation for tax purposes would further reduce this danger for corporations with good immediate prospects, but with un-

favorable long-run prospects. And since for most corporations the distant future is a dark imponderable, rapid depreciation might generally reduce the deterrents to investment. Such a policy might operate, however, as the carry-backs do, to the advantage of established corporations as compared with struggling new concerns. An established concern with a large income could take full advantage of the allowance, while in many instances a new firm with little income against which to charge the larger amount of depreciation, would derive only minor benefits from it. But the fact that small and expanding businesses are generally more interested in accelerated depreciation than large and established firms may indicate that the benefits would not be restricted to large corporations. It must be remembered also that if corporations were required to adopt the same accounting methods in statements to stockholders as in their tax returns, rapid depreciation might so reduce apparent profits as to cause stockholders to regard expansion with disfavor.

A step in the direction of accelerated depreciation was taken in October 1946 when the Treasury issued a ruling which, under certain conditions, permits the use of the "declining balance" method of computing depreciation for tax purposes. Prior to that time, except in the case of rental housing, the Treasury had refused to approve or disapprove the use of this method in advance of auditing the taxpayer's return. The purpose of this system is to throw the heaviest burden of depreciation against the early life of the asset with annual depreciation charges decreasing gradually as the asset ages. This result is obtained by applying the depreciation rate to the depreciated value of the asset each year, rather than to its original cost, as under the "straight line" equal installment method most commonly used.

Chapter 41

SMALL BUSINESS

We hear a great deal these days about the difficulties of the little businessman in the big world. He is beset with many problems, and not the least of these is taxes.

The phrase "small business" has probably always had emotional connotations. Everyone is vocally for it and discussion of the subject is almost constant. Between 1933 and 1943 Congress passed twenty-six laws to help small business. Yet to date little has been accomplished of any definite value.

In considering the problems of small business our first task is to determine what we are talking about. Just what is small business? When Maury Maverick was chairman of the Smaller War Plants Corporation, he suggested that it was any business which could not afford a lobbyist in Washington. Most businessmen use the phrase loosely without any clear conception of exactly what they mean. Is a business small or large according to the amount of capital invested in it, or according to the amount of money it earns or according to the number of people it employs? Upon examination, all of these criteria prove fugitive. A million dollars may be a big investment in a hairpin manufacturing establishment, but a very small investment for an automobile plant. The corner grocery may have two employees and the "small" machine-tool factory 200.

Do we measure each separate corporate entity without regard to affiliation or ownership? Is a small subsidiary of the United States Steel Corporation small business? Is a $100,000 corporation owned by John D. Rockefeller small business? Or do we look beyond corporate entity and rule out small corporations which really enjoy the advantages of big business position? The answer depends upon where you sit, and is not clear wherever you sit.

Ernest J. Hopkins of the Federal Reserve Board's research staff has suggested that the meaning of small business is to be "described" rather than defined. In its aggregate sense, he says that small business refers "to that portion of a given industry, an industry group, or of business as a whole, that is made up of relatively small and functionally individual units." By connotation what is involved is an order of economic life, with distinct sociological implications, that is broadly associated with the lower extreme of business size. The Department of Commerce, in presenting $50,000 annual sales or receipts in retail trade, service and construction; $200,000 annual sales in wholesale trade; and the employment of 100 workers in manufacturing, as the upper limit of business smallness, is careful to use the term "understanding" rather than "definition."

Many people fervently believe that small business is the seedbed of future economic growth. One estimate indicates that small concerns constitute a good third of our commerce and industry. President Truman, in his Budget Message of January 1946, said:

> Actually when we talk about small business we are talking about almost all of the nation's individual businesses. Nine out of every ten concerns fall into this category, and 45 percent of all workers are employed by them. Between 30 and 40 percent of the total value of all business transactions are handled by small business.

One of the fundamental approaches to the job of encouraging small business, the President continued, must be based on "arrangements for making private and public financial resources available on reasonable terms." In his State of the Union Message in January 1947, Mr. Truman pointed out that assistance to small business in obtaining credit was "particularly important at this time when thousands of veterans who are potential business and industrial leaders are beginning their careers."

Although a recent Federal Reserve Board study shows that small concerns have been more profitable in recent years than larger companies, the reluctance of funds to flow into small and personal ventures is an acute problem. Most of the local banks upon which small businessmen depend are themselves too small to afford the risks involved in supplying enough credit to small firms. A number of recent plans to encourage small enterprises are designed to help them raise capital from both private and public sources.

Since the war, groups of large commercial banks have offered central protection to small banks through a form of credit pool that permits outright loan participations rather than the insurance type of guarantees. In addition to making direct loans, the Reconstruction Finance Corporation, backed with Federal funds, has shared unusual risks by guaranteeing private bank loans up to 75 percent of their face amount. Formerly, these guarantees were made on an automatic blanket participation basis without individual examination of risks, but with certain standard requirements. The Reconstruction Finance Corporation discontinued making guarantees on this automatic basis in January 1947, but is still guaranteeing private bank loans up to 75-percent coverage against loss for a small percentage charge based on the amount of the loan and after an individual local check.

A legislative proposal made early in 1947 would liberalize the present authority of the Federal Reserve banks in the field of guaranteeing bank loans to business enterprises by empowering these twelve regional institutions to underwrite up to 90 percent of loans made by commercial banks to businesses. The local bank which made the loan would be required to assume at least 10 percent of the risk. The Federal Reserve banks would guarantee the loans for a fee which would be part of the interest charge made by the commercial bank to which the borrower originally applied.

One virtue of both the Reconstruction Finance Corporation and Federal Reserve guarantee plans is that no outlay of government funds is required except in unusual cases and in a period of recession. Another virtue is that a borrower cannot go directly to the government for a guarantee, but first has to convince his local banker that he deserves help. The banker is familiar with the applicant's character and capacities and can exercise sound judgment upon the risk involved. Under both plans bank loans can be made to small businesses which, with few exceptions, would not have been made without government protection. Furthermore, the guarantee mechanism has proved to be the simplest, most economical and most satisfactory way to handle a large volume of small loans, since loans handled on a direct basis by any government agency require tremendously increased personnel and expense.

The inability of small business to raise funds in the capital markets is the underlying theme of many tax proposals. Some of the problems

arise because the present tax structure tends to prevent business from plowing back earnings. Because frequently they are not firmly established, small businesses may have plans for new lines and the promotion of old products, but are handicapped under present tax law in accumulating financial reserves to compete with older firms which have established reserves in a more favorable tax climate. Other problems arise because small firms are less likely to offset their losses than established firms.

Most of the proposals to aid small business move in the direction of preferential tax treatment. These suggestions include graduation in the corporate rates, tax exemption during the early years for new businesses, a flat exemption of the first $25,000 to $50,000 of the net earnings of all corporations, and permission to treat outlays for research and development as current expenses to be charged against current income. Additional recommendations are deductions for plant and expansion by new enterprises, tax aid to companies financing small business, and tax credits for increased employment and for equity investment in small business. Many of these suggestions involve difficult differentiations and serious administrative problems.

The small businessman is prepared to meet the challenge of stiff competition, but not unfair competition. Some people propose that taxes should be used to protect little business against monopolies. But special treatment of corporations not engaged in monopolistic practices, as proposed in a bill introduced in the Senate a few years ago, is a dubious panacea for small business ills. Federal policy is opposed to monopoly and such a differentiation might be basically in accord with that policy. But monopoly is an elusive concept. Size does not prove its existence, nor do interlocking directorships. No doubt there is a connection between size in business and monopoly power, but bigness does not always beget monopolies nor does smallness always mean the absence of monopoly. It is almost impossible to devise any test that would be readily useful for tax purposes.

Moreover, a differential in favor of independent firms would have significant limitations. If the differential were based upon income, it would have little influence where business is carried on at a loss. This would make it a very blunt instrument in a large number of cases; from 1920 through 1941 the percent of corporations in the country reporting deficits was never less than thirty-four and in one year it was as high as

seventy-two. Many corporations are still operating at a loss, even though times have considerably improved. Furthermore, the size of a corporation's income is no indication of the rate of return upon its investment or the size of the income of its owners. A small concern may, and often does, earn relatively more on its investment than a large corporation. Many persons with modest incomes have bought shares of large income corporations, and many persons with substantial incomes have invested in small income corporations.

Nor would preferential tax treatment for independent firms afford any additional stimulus to competition in industries in which competitive conditions now prevail. A monopoly is not very likely to occur, for example, in the women's and children's garment industry, which in 1935 was composed of more than 6,000 establishments, the eight largest of which accounted for only about 2½ percent of the volume of total output. Incentive taxation in favor of independents would be a form of bounty in this industry which could have little or no influence over the business practices of units within the industry.

In no sense do I hold a brief for monopolistic practices. I am only questioning the use of tax devices to curb monopoly. On this point the Committee for Economic Development advanced as one reason for repealing the excess-profits tax soon after the war that the tax was too crude an instrument to recapture monopoly profits. Moreover, a tax penalty on bigness is hardly the best way to maintain a high level of total business investment by small and large firms combined.

In the end, the small businessman must select the road that leads him to the right destination. He will not solve his problem by direct pressures which result in special favors or subsidies in his own behalf. He needs more than crumbs from the table. He wants to sit down to a good meal. His prime interest—his enlightened self-interest—lies in a sound tax system for the nation as a whole rather than special tax concessions for himself. He does not exist in a vacuum. His business will flourish best in a favorable social and economic climate. It will flourish best under conditions which permit all business, big and small, to prosper as the people prosper.

A sound tax system will materially help toward full employment and a high national income. The small businessman, as well as the big businessman, needs the vision to see that maintaining high levels of production and employment in the United States will contribute to peace and

prosperity throughout the world. He needs to see that depression here will foster depression abroad, and that prosperity here will foster prosperity abroad. These hard facts are of particular concern to the small businessman because he is especially vulnerable to depressions. Slack employment means reduced purchasing power, and reduced purchasing power means a depression in which the small businessman suffers most. He lacks the financial reserve to ride the storm. He loses customers first when purchasing power drops. The gigantic aggregate of machines and plant and capital that add up to big business is not in this precarious position. It may wait out a depression. True, its profits and its dividends may drop. But the odds are that it will be able to stay in the black without a trace of red, while the small businessman finds himself in the red without a trace of black. Even if a big business loses money, large reserves reconcile it to temporary inactivity. It can keep the wolf at bay. Many of its small competitors will perish by the wayside, but it will be ready to forge ahead when recovery comes.

Perhaps the small businessman should adopt a new philosophy. Of course his own taxes are important. In many cases they will determine whether he will sink or swim. But often tax rates go merely to the question of how much profit a man has after taxes. The more basic question is whether he will have any profit at all. The small businessman will do well to shift his sights from his own taxes to the other fellow's taxes, to the whole tax system, to a fresh analysis of what taxes will best promote an economic climate in which we can prosper and grow. For that is the climate we need to foster the all-pervading and restless activity, the superabundant force and energy which are the components of the America we want in the years ahead.

Chapter 42

THE EFFECT OF HIGH CORPORATION TAX RATES

No MATTER which way we turn in trying to adapt our corporation tax system to long-term future needs, we may expect to hear much talk about the harmful effect of corporation taxes upon risk-taking. Wartime rates were accepted as a temporary, although necessary, evil with the reservation in many minds that if long retained they would crush industry. But the repeal of the excess-profits tax has not silenced the people who object to corporation taxes. The argument that high rates hinder business expansion and even cripple corporate enterprise will doubtless still be made. When that argument is heard in the future, history may be cited in rebuttal. For experience with the highest corporation tax rates the United States has ever known reveals that, far from being crushed, corporations fared better during the war period than ever before in terms of profits after taxes and after renegotiation.

Before the war corporations were averaging profits of a little more than $3,000,000,000 a year after taxes. The average for the years 1936 to 1939, the base-period years used to measure excess profits, was $3,300,000,000. During the war corporation profits after taxes and after renegotiation averaged about $7,700,000,000 a year, more than doubling prewar levels. In the six-year war period, 1940 through 1945, corporate net profits after taxes and after renegotiation totaled over $46,000,000,000. Treasury figures for the various years were:

Year	Profits
1940	$4,800,000,000
1941	7,300,000,000
1942	9,000,000,000
1943	10,000,000,000
1944	8,700,000,000
1945	6,800,000,000

These figures include all corporations, large and small, profitable and unprofitable.[1] They include many corporations which were losing money during the war. The figures for profitable corporations alone after taxes and after renegotiation give a still better indication of the net profits of the money-makers which, prior to the war, averaged profits after taxes of about $5,600,000,000 a year. The figures for the various years were:

Year	Profits
1940	$7,000,000,000
1941	9,000,000,000
1942	10,000,000,000
1943	10,800,000,000
1944	10,000,000,000
1945	8,700,000,000

For all corporations during the same six-year period, the excess of each year's income after taxes and after renegotiation over the average 1936 to 1939 level is expected to aggregate $27,000,000,000, or over eight years' average prewar income after taxes. In other words, in this six-year war period American industry made as much as it would have made in fourteen years at the prewar level of profits.

Of course, taxes rose; they were multiplied many times. Total corporate liabilities for income and excess-profits taxes amounted to slightly over $2,500,000,000 for 1940. They amounted to more than $12,000,000,000 for 1942, almost $16,000,000,000 for 1943, over $14,500,000,000 for 1944 and more than $11,000,000,000 for 1945. The increase in net profits, which averaged more than 200 percent before taxes for all corporations—from a little over $7,000,000,000 in 1940 to more than $21,000,000,000 in 1942, nearly $26,000,000,000 in 1943, over $23,000,000,000 in 1944 and about $18,000,000,000 in 1945—was not matched by the increase in net profits after taxes and after renegotiation, which averaged less than 85 percent. Nevertheless, profits remaining in the hands of the corporations were the highest in history.

There is little evidence to support the contention that war profits were theoretical profits tied up in brick and mortar, for the working

[1] The President's Economic Report and the Department of Commerce have estimated the net profits of all corporations at approximately $9,000,000,000 for 1945.

capital of industry has increased remarkably since 1940 and is in extremely liquid form. Recent studies show that the increase in liquidity is uniform throughout different industrial groups, both large and small. Of course, some individual companies have not fared as well as others in this respect. But in the aggregate, corporations came out of the war in the best financial condition they have enjoyed for decades.

Securities and Exchange Commission figures show that from December 1940 to October 1946 current assets of all corporations rose from $60,300,000,000 to $98,900,000,000, current liabilities from $32,800,000,000 to $43,500,000,000. The difference between the two, the net working capital, thus rose from $27,500,000,000 to $55,400,000,000. Most of the increase in current assets was in cash and government securities. Cash on hand and in banks increased from $13,100,000,000 to $22,300,000,000. Holdings of government securities rose from $1,900,000,000 to $16,200,000,000. The ratio of corporate liquid funds in the form of cash and government securities to sales, which is one rough measure of liquidity, was far above prewar levels. The largest part of the increase in current liabilities from 1940 represented taxes due the Federal Government. However, corporations' holdings of government securities alone in October 1946 were $7,500,000,000 higher than their Federal income tax liabilities.

The moral of this story is that high corporation tax rates do not invariably have a destructive effect on business enterprise. They do not crush industry, if they are imposed in an economy with virtually full employment and a high national income. Undeniably that *if* is a big one. But under these conditions corporations have a wide market for their products and enough profits after taxes for reasonable dividends and considerable expansion.

Chapter 43

A FEDERAL SALES TAX

WE WENT through the war without a Federal sales tax. But it would be most unsafe to say that our postwar Federal tax structure is immune from sales taxation.

The sales tax never lacks advocates. The Twin Cities Postwar Tax Plan suggests and argues for a general sales tax without exemptions at the "moderate" rate of 5 percent. The Commerce and Industry Association of New York has recommended for the postwar tax structure a flat rate general sales tax "with such exemptions as might be necessary to prevent double or pyramiding taxation as might occur in the case of agriculture." The Committee on Postwar Tax Policy counsels that when the point is reached that selective excises and a progressive income tax are insufficient to meet revenue needs caused by Federal expenditures, then "objections to a Federal sales tax should seem less important as compared with the inflationary dangers caused by continued and persistent deficit financing." In agreeable contrast, the Ruml-Sonne plan takes a strong position against a Federal sales tax, and the Committee for Economic Development concludes that "excise and sales taxes should be lightened as much as total revenues will permit."

Some of the arguments against a Federal sales tax in wartime become irrelevant when we are discussing postwar taxes. We need no longer be concerned with the effect of a sales tax upon our price control and wage stabilization programs. Nor do we have to worry so acutely about diversion of manpower and equipment to enforcement of the tax, although many administrative difficulties would remain, particularly if exemptions were allowed. But we should still have to consider how the tax would distribute the cost of government among the people, and whether it would help or hinder us along the road to prosperity.

A sales tax hits heaviest the low income groups, all of whose incomes

are spent on consumers' goods. It would bite deeply into the incomes of millions of people who depend upon fixed low wages, pensions or allotments, or checks from governmental agencies, and who have been hard pressed by rises in the cost of living. In this group are more than 2,000,000 aged persons on state public assistance rolls. Over 3,000,000 are disabled veterans drawing pensions or disability compensation, or the widows and dependent children of veterans. One hundred and fifty-eight thousand are retired and disabled firemen, policemen, and state and municipal employees receiving pensions or retirement pay. Eight hundred thousand are dependent children receiving aid through Federal and state welfare funds. Over 57,000 are needy blind carried on Federal-state assistance rolls. Nearly 1,700,000 are retired workers, widows and young children receiving social security payments under the old-age and survivors insurance program.

If we imposed a sales tax large enough to equal 10 percent of the income of persons with annual incomes under $500, the tax would amount to only 6½ percent of income at the $2,000 to $2,500 level, and 2 percent of income for persons earning more than $10,000. It would be similar to imposing an income tax without exemptions at the rate of 10 percent on an income of $500, 6½ percent on an income of $2,500, and 2 percent on incomes above $10,000. We would not consider imposing such a regressive rate structure under an income tax, but that is the way a sales tax would distribute the burden. The man who must spend every cent he makes for bare necessities is certainly not better able to pay taxes than the man who can buy basic supplies and still have something left over for a rainy day.

Since the chief impact of the sales tax is upon the low income groups, the tax would cut down spending power. People would spend less money because spending is largely concentrated in income brackets where there would be no choice but to spend less or dip into meager savings. Hence the tax is deflationary in its influence and harmful in periods of low consumer spending. Moreover, the tax would fail appreciably to perform the function of offsetting oversaving and thus helping to prevent depressions, for most savings are concentrated in the income brackets above those where a sales tax would hit hardest.

On the grounds of equity and sound economic policy our postwar tax structure should not include a Federal sales tax. For some time we shall doubtless continue to have low income tax exemptions and a

broad tax base. We may accomplish the objective of curbing booms by other instruments than a sales tax. Deflationary pressure may be supplied when we need it by imposing excise taxes and by adjusting income tax rates; the income tax always carries an exemption which protects the lowest incomes. Another instrument would be a spendings tax with exemptions and graduated rates. By such devices we may check inflationary movements without doing the injustice of imposing a tax where there is no ability to pay.

Chapter 44

TAX ADMINISTRATION

1. *The Place of the Courts in the Taxing Process*

FAMILIARITY with the contents of tax statutes is only the beginning of wisdom in the present tax era. To follow through from the academic to the practical it is necessary to know how our tax laws operate, and to examine with some care the defects in the administrative end of the tax-gathering process. Only then will it be possible to provide remedies that will enable our tax system to pass its final pragmatic test of workability.

The sheer bulk of our tax law is one of its most forbidding characteristics. The Revenue Act of 1913 modestly contented itself with 14 subsections; the income tax statute has gradually grown to the Gargantuan proportions of about 200 sections. This total does not include the excess-profits and unjust enrichment taxes. The estate, gift and excise taxes comprise additional sections. The complete Internal Revenue Code runs to almost 1,300 sections.

Even at that our statute law is a paragon of brevity compared with other parts of tax law. Tax laws enacted by Congress must be interpreted. Regulations issued by the Treasury are the most authentic Treasury interpretations of the statute. Like tax statutes, regulations are multiplying. The initial income tax regulations, issued in 1914, comprised 130 pages; the latest income tax regulations run to 1,300 pages. However, these pages are not enough for a full explanation of the meaning of the statute in specific application; there will soon be fifty volumes of *Cumulative Bulletins* containing published rulings of a less formal character than regulations. Thousands of informal rulings never achieve the dignity of publication.

The matter does not end here. The final meaning of our tax statutes

is not revealed by Treasury regulations and rulings. We are operating under the Internal Revenue Code. The code is not only what the regulations say it is; it is also and primarily what the courts say it is.

In one sense, the Federal courts are at the apex of a vast tax pyramid. In the fiscal year 1945 all of the courts, including the Tax Court, decided about 1,700 tax cases. Of this total 475 were decided in the circuit courts of appeals and 18 by the Supreme Court. This is a sizable number in both an absolute and a relative sense. The odds are 1 to 5 that a random opening of any recent *Federal Report* will bring a tax case. The odds are 1 to 7 for the *Supreme Court Reports*. These odds clearly indicate that tax cases constitute a large proportion of cases decided by our Federal courts; in fact, these courts decide more tax cases than any other type of case.

But statistics have an exactness which is sometimes no more than delusive. Our revenue system produces much more controversy than court statistics reveal. In the fiscal year 1945 adjustments were proposed upon about 560,000 income, profits, estate and gift tax returns; the totals for the two previous fiscal years were almost as high. But only a small number of these tax controversies ever reach the courts. In 1945 about 510,000 controversies were closed without protests; about 33,000 were closed by the Conference Section; and about 4,300 were settled in the Technical Staff. These figures show, of course, that a very large proportion of tax controversies is disposed of at the administrative level, and that the top of the tax pyramid is unimportant in terms of cubic content.

The importance of the courts in the taxing process does not derive merely from the fact that tax cases constitute a relatively large proportion of all decided cases. The importance of the courts is largely attributable to the broad function which inertia has bestowed upon them. By default, more than by design, they have been assigned virtually the entire job of interpreting our tax statutes. Apart from Congress, they have come to be regarded as the almost exclusive voice of authority. Their decisions serve as precedents, as they should. In addition, however, we have sunk into a mire of administrative inaction while we wait passively for their future instructions. The courts, therefore, have too big a job. And they are almost impossibly handicapped in doing that job, not because they are incompetent or unwise, but because they are not fitted by experience or other qualifications for a

job involving policy as well as law. At best, they would be wholly competent to interpret our tax statutes in the interstices left by a body having more intimate contact with the policy underlying our revenue laws, and to provide a brake on administrative indiscretion and a substitute for administrative inaction.

Criticism of our courts is voiced nowadays on all sides. They are accused of pursuing too eagerly those who seek to avoid taxes. A favorite epithet is "judicial legislation." Even worse, the courts are charged with the unforgivable sin of changing their minds too often. The result is said to be uncertainty which prevents taxpayers and their attorneys from having double-barreled assurance about the tax consequences of business activities. Businessmen contend that they cannot make deals without advance knowledge of the law, and lawyers claim that they are unable to advise their clients now as they could in the dear dead days, never wholly beyond the recall of lawyers, when they like to think the behavior of the courts was more circumspect.

These criticisms are aimed at the wrong target. It is true that the prevention of tax avoidance sometimes becomes a Herod's massacre in which the innocent are trapped along with the guilty. But tax avoiders often take long chances. And it is always easy to use the inflammatory phrase "judicial legislation." But judicial legislation is one of the facts of tax life; it is not iniquitous *per se*—certainly not when the choice before the court is to bless or thwart tax avoidance. Attainable certainty is a desideratum devoutly to be wished, and avoidable uncertainty is a dereliction wholeheartedly to be deplored. But, after all, a doctrine that stiffly refused to countenance self-correction or adjustment would be completely unrealistic in ordinary times; in a period when change in our economic and social order is proceeding at its present dizzy pace, a doctrine of this kind would be almost fantastic. We are living today, not yesterday, and we should call unavoidable uncertainty by its right name. It is the flexibility that makes modern tax law tolerable.

The conventional approach to the problem of administration is that Congress, in enacting a statute, has a specific intention about every particular case. The theory, dubbed the "Christopher Columbus theory" by Judge Jerome Frank, is that the only necessity is to ascertain that intention. To this school of thought legislative intention has a Platonic or ideal existence, which the courts later discover.

Professor John Chipman Gray attempted to dispose of this fiction almost forty years ago; but it refuses to disappear. As Professor Gray put it, "It is not once in a hundred times that any doubt arises" as to the intention of the legislative body. "If that were all that a judge had to do with a statute, interpretation of statutes, instead of being one of the most difficult of a judge's duties, would be extremely easy." Difficulties arise because judges are asked to supply a nonexistent intention. Yet judges, and others who should know better, persist in saying that Congress intended a certain result. Even the sophisticated Mr. Justice Cardozo sometimes clung to this logic. But, to paraphrase a well-known observation of Mr. Justice Holmes, legislative intention is sometimes little more than a brooding omnipresence in the sky. The results attained by the accepted process of interpretation are not synonymous with actual intention. The whole concept of legislative intention, as we know it today, is archaic.

It would be bad enough if the problem were merely to discover the intentions of one or two persons. But tax laws are passed by several hundred legislators. Many of them may have been absent when a bill was voted. Others may have voted out of party discipline rather than sympathetic understanding. Legislators cannot devote themselves to all the minutiae of legislation; they are not even expected to do so. The 208 pages of the Revenue Act of 1942 are hardly a detailed statement of Congressional intention. As a matter of fact, legislative intention is irrelevant. The basic problem is what the statute means, not what the legislature intended.

We are not out of the woods when we explode the myth of legislative intent and agree that the question is the meaning of words in a statute as related to a group of facts. Interpretation is a process of ascertaining and justifying a selected meaning for the words of others. We are making progress if we admit that the hopes and aspirations underlying a tax statute are those of a small group consisting of a special legislative committee and their drafting technicians. Congressional approval of a revenue act is little more than a general acceptance of broad premises of public interest, and the Congressional vote is usually mere acquiescence in the detailed report of others. To find the correct meaning it is necessary to go to explanatory statements in committee reports and to statements made on the floor by members in charge of a bill. The statements of other members of Congress offer little of value, since they reflect nothing more than individual views.

Sometimes these reports and statements reveal a purpose which precisely fits the occasion. But legislators are only human and cannot anticipate all situations. There always remain many actual patterns which defy the most imaginative ability to foresee. Then the court must examine all possible meanings of the language used and select the most satisfactory meaning that the words in the statute will honestly sustain. The judge, being highly sensitive to the consequences of competing interpretations, must determine the most sensible result within verbal limitations set by others. Ordinarily there is no real question of right or wrong. The question is rather whether an interpretation is wise, foolish or indifferent, when appraised alongside of statutory language and the legislative materials. Dean Griswold has rightly declared: "The whole field is essentially one of administration rather than of law."

When we once decide that questions of statutory interpretation are not questions of right or wrong or of finding the only correct rule to fit the occasion, but are rather questions of policy in shadowy territory, we come closer to understanding the problem to be resolved. And we know who can best perform the task of interpretation. It is a task calling for skilled and sensitive wisdom, operating on a highly technical level, rather than for the traditional learning of judges. Tax cases are hard cases. They make heavy demands upon the experience, skill and judicial faculties of judges. Most judges are not, and do not claim to be, tax experts. However great their legal training and native intelligence, they are not always in a position to discharge completely the responsibility of deciding the policy underlying thousands of statutory provisions in a special field of law. They have not participated in the formulation of tax policy and the drafting of language with the enclosed meaning of tax statutes. They must contemplate the tax system from without, rather than from within. They cannot know the premises and fine distinctions which the statutory language is designed to cover. They have not the time to spend on these complicated matters. They cannot be expected to learn in the brief period available to them the many delicate relationships which link one tax provision to another, and then to formulate rules of law which can be translated into sound results.

The very factors which disqualify the courts point to the Treasury as the logical administrative body. It is inured to a daily diet of complexities. It is constantly operating at the technical level where prob-

lems have definite outlines. It has learned through grim necessity, as well as contact, the relationships between one taxing provision and another. It has a weather eye on results as well as rules. It is in the best of positions to determine results in the light of administrative feasibility, experience derived from concrete applications of principle and the demands of new needs and circumstances. It is uniquely qualified to fashion an integrated policy which covers an entire tax area rather than an isolated case. It participates actively in the formulation of tax policy as well as in the process of drafting tax laws. In interpreting tax statutes it would operate on home territory. Moreover, it has a legislative delegation of authority; it may prescribe "all needful rules and regulations" for the enforcement of the provisions of the Internal Revenue Code.

There will be many who will object to giving the Treasury greater administrative authority. Some people will contend that Congress is the proper rule-making body because it is just as easy to be specific by legislation as by regulation. The short answer to this argument is that the problem is what to do when there is no specific legislation. Moreover, the legislative process is too unwieldy to react sensitively and quickly to each tax dilemma. Revenue acts are not always passed annually, and legislation, even when drafted with the greatest regard for specific situations, often fails to encompass situations that arise in later experience. The choice is between the present unsatisfactory method of litigation and more administrative finality. If the area of supplementary rule-making power were extended, Congress would be freed to devote much more of its time and energy to fundamental problems of tax policy. Surely no one will gainsay that it needs all of its wisdom in that area in the future.

Still others will question whether the Treasury is to be trusted with more freedom to make rules. The Treasury, they will contend, is a tax-gathering agency; as a tax collector, naturally it would resolve doubts in its own favor and the taxpayers would come out at the short end of the horn. History does not wholly support this contention. The record of the Treasury reveals that sometimes it has been more generous than it needed to be. However, there is danger that the Treasury would sometimes overstep reasonable bounds to its own advantage; other parts of the record disclose that the Treasury on occasion has been considerably less than judicial. Of course, temptations go with freedom.

But the possibility that the Treasury might abuse its power is not a good enough reason to withhold that power, especially when the courts and Congress would serve as checks upon its exercise.

If the Treasury is incapable of using its rule-making power wisely, perhaps we should reorganize the Treasury. The ideal of attainable certainty can hardly be reached unless the Treasury exercises more freely the power it now has. Congress and the courts cannot supply sound rules quickly. If the Treasury is, at the moment, temperamentally, or in other ways, disqualified to do the job, the answer is not to continue to rely upon other branches of the government which are permanently and more basically disqualified, but rather to get a better Treasury. There is room for improvement in the Treasury, as there is everywhere in government. But we can afford to take our chances in the hands of the Treasury, when we have so much to gain and so little to lose.

Some people will say that the Tax Court is the appropriate administrative body. But the Tax Court is essentially a nonadministrative body. It is functionally incapable of making rules; it was never meant to do so. It acts pre-eminently in a judicial role. It is passive rather than dynamic, and can deal with generic problems only as they are presented in the context of particular litigation. It is wholly dependent upon the exigencies of litigation for the presentation of problems. Some of the most unimportant problems are put to the Tax Court promptly. Some of the most important problems reach the court belatedly or, perhaps, not at all. The whole process of selection is without sense or principle. It partakes of the nature of an uncontrolled experiment. Tax administration calls for a more controlled type of experiment. It must have order and plan. It requires the expert attention of a highly competent tribunal which knows the whole story of tax law—not only the end of a controversy but also its dim beginnings.

The courts, like Congress, would still have plenty to do if the Treasury exerted its rule-making power to the utmost. The Treasury might overlook problems which should be handled by regulation. The lower courts would still have to decide disputes about the facts out of which legal consequences ensue. The lower and appellate courts would still have to decide cases in which it was claimed that the rule applied transcended reason. The statute would become like the Constitution, a grant of power which might be exercised in a number of different ways;

the function of the courts would be analogous to the Supreme Court's position when constitutional questions are presented to it. The courts would not disturb a rule because they might have decided originally upon a different rule, if the rule established by the Treasury had "a reasonable basis in the law." But they would stand as a final guardian of taxpayers' rights under the law, ready to reverse the Treasury when it stretched the law beyond reasonable limits.

2. *A Single Court of Tax Appeals*

It is more fortunate than most of us realize that tax law is a fluid approximation, constantly shifting its center of gravity to fill the new needs of a fast-changing world. But a virtue can become a vice if it is carried too far. The virtue of tax law flexibility is its adaptability; there is no value in change for its own sake. Stability, too, is a virtue upon occasion. Taxpayers are entitled to know where they are insofar as the certainty required does not stunt the growth of the law.

A typical scene in a tax lawyer's office will illustrate one of the most critical problems in tax law. Mr. Smith is asking his lawyer whether a recent decision of the Tax Court settles his own case. The news letter in which he has read an account of the decision clearly indicates that it is a parallel case. The decision was in the taxpayer's favor. Mr. Smith is surprised when his lawyer shrugs his shoulders. "No, the opinion is carefully reasoned and most convincing," the lawyer admits, "but Tax Court decisions are subject to review in eleven courts of appeals. How do we know what will happen on appeal? All I can say is that it is just as well that the decision was not the other way."

Mr. Smith is puzzled. A precedent in his favor does not seem to impress his lawyer. In due time, however, there is a decision on appeal in favor of the taxpayer in the parallel case. Mr. Smith returns to his lawyer with enthusiasm. Now surely he will be impressed. They have a decision in their favor in an appellate court. But the lawyer is still apathetic. He points out that they do not have a Supreme Court decision in their favor. This case probably cannot get to that court because there is no decision in conflict with it. Someday perhaps another case will start in another part of the country, work its way through the same process, and a conflicting decision may develop in another circuit court. That may take many years, and may never hap-

pen because other circuits may agree. Until it does happen, nobody—the taxpayer, his counsel, the government, its counsel—has anything definite on which to rely. Mr. Smith goes away sorrowful. Tax law has strange, but not very wonderful, ways.

The tax lawyer might have given the client an example of these ways. A man once left a trust in favor of his widow. Controversy developed as to how the widow should be taxed on the income from the trust. The Treasury undertook to tax the income received in 1917 and 1918 to the widow like the income of any ordinary trust. But the widow's lawyer argued that in effect she had bought her interest in the trust by giving up her rights to dower, and that she should not pay any tax until the payments from the trust equaled the value of the dower interest she had surrendered to obtain her trust interest. The Second Circuit Court of Appeals in 1926 decided that this was a good argument. But the government—quite properly under the procedural system existing in tax law—persisted in trying to tax widows in similar situations until it was unsuccessful in two other circuit courts of appeals. Then the Commissioner of Internal Revenue decided that he had tried long enough and that he should not harass widows any further. Therefore in 1929 he issued a ruling that widows should not be taxed in such cases.

But if widows were not taxable, somebody else must be taxable. The Commissioner tried to tax the trustee of the trust, but some trustees resisted. The same question started another weary journey through the courts, reaching the Supreme Court in 1933. There the Commissioner argued that the trustee should be taxed if the widow could not be taxed, but his real position was that widows were taxable. The Supreme Court agreed. Seven years after the first decision of a circuit court of appeals the other way, and sixteen years after the first of the tax years in which the income had been received by the trust, widows became taxable by order of the Supreme Court. In all these years many thousands of controversies had to be argued and adjusted in some way for want of an authoritative rule on a homely tax question. However, confusion persisted for many years after the question was finally settled; the Supreme Court decided another phase of the same question in 1937; and the Supreme Judicial Court of Massachusetts had to decide a question in this field of law as recently as 1941. It is hard to believe that such a story is not lifted from Dickens, rather than from the American law reports of the twentieth century.

The story of the widow could be multiplied many times. And there is a solution which has not been tried. We should redesign our system for judicial review of tax cases. Tax revenue collected during the war years was more than ten times the average for the ten years preceding 1940. A tenfold increase in revenue is bound to mean a large increase in the number and complexity of tax controversies. The burden of handling these cases will fall primarily on the Bureau of Internal Revenue. The Bureau will decide these cases according to rules it has made. But the courts will have to prescribe additional rules and correct the Treasury upon occasion. This important judicial function should be exercised promptly and surely. Delay and discrimination are grievous faults when so large a proportion of taxpayers' annual income is taken by taxes.

At the present time most of the tax cases which get into court start in the Tax Court of the United States. Tax cases may also be commenced in any of the ninety-odd district courts of the United States, in the Court of Claims, and, occasionally, in state courts. Appeals from the district courts and the Tax Court go to the ten circuit courts of appeals and the United States Court of Appeals for the District of Columbia. The tax decisions of these courts and of the Court of Claims are reviewable by the Supreme Court only by special permission, which is usually unobtainable until a conflict of decisions has developed. Thus, it is not enough to litigate a tax question once. It must be litigated two or three or four times. The question almost always remains open until a conflict develops. And the process of obtaining a conflict often takes an inordinately long time. In any event, it is beyond the control of the ordinary taxpayer, and thus largely fortuitous in its operation in specific cases. The resulting uncertainty causes much difficulty and delay in tax administration, and is the basis of a large part of the dissatisfaction with the present administration of tax laws.

The delay and discrimination inherent in this system of judicial review stand out clearly if we examine the work of the Supreme Court for a recent calendar year. During 1943 the court decided twenty-one Federal tax cases. Of this number, two involved questions of liens for estate taxes. Three involved questions of estate tax liability; one of the decedents died in 1935, and the two others in 1936. Thus it took from seven to eight years for an estate tax question to get through the Supreme Court. Two of the cases involved questions of tax liability on

gifts made in 1936 and 1937. It took from six to seven years to get these gift tax questions decided by the Supreme Court. Of the remaining cases, one was criminal. The case came to the Supreme Court because of a conflict with two previous cases decided in 1931 and 1932. The first of these cases arose out of a tax return which was filed in 1926. It was seventeen years after that return was filed before the question at issue was finally passed upon by the Supreme Court. One of the remaining cases involved an excise tax for the year 1934. It reached the Supreme Court because of a conflict with a decision rendered in 1938, likewise involving the year 1934. The decision of the Supreme Court was contrary to the decision in the 1938 case. Thus, the point was finally settled nine years after the tax was due, and in a way which was contrary to the decision which had been applied in the case of the great majority of the taxpayers who were affected by the tax.

The remaining twelve cases involved income tax liability for years from 1935 through 1939. In nearly every case the question reached the Supreme Court many years after the tax was due, and then only because of a conflict. The conflicting decision was rendered as long ago in one case as 1933, and the tax year involved in that case was 1921. Thus, it was about twenty-two years before that particular complexity was resolved. The years involved in the conflicting decisions in the other income tax cases ranged from 1929 through 1938. In the cases decided by the Supreme Court in the calendar year 1943, it was on the average at least ten years from the time the point was first raised until it was finally authoritatively decided.

This is no criticism of the Supreme Court. No one who is familiar with the work of that court could criticize it for delay. The difficulty is not with the time the Supreme Court takes on cases after they reach it, but with the time required to get a question actually before the court. It is true that the court could help a great deal even under our present system by making less of a fetish of the conflict test as a basis for granting certiorari. The court could exercise a greater instinct for the vital Federal tax questions, and grant certiorari the first time such a question appeared. But this would not go to the heart of the problem. Many of the questions on which authoritative rules are needed are not striking questions. There are more of these cases than the Supreme Court could handle consistently with its important duties in other fields of the law.

A way out of this difficulty has been suggested by Dean Griswold.

It is earnestly advocated in some quarters; there is a good deal less than enthusiasm in others. The proposal is to relieve the circuit courts of appeals entirely of their duties in Federal civil tax cases, and to transfer these cases to a new tribunal. This new court would have exclusive jurisdiction to review all civil decisions in Federal tax cases of the district courts and of the Tax Court. As to tax appeals, it would supersede the ten circuit courts of appeals and the Court of Appeals for the District of Columbia. Appeals from Federal tax decisions of the Court of Claims could also go to this court so that final authority in all Federal tax matters might be centralized in one tribunal. Attention will be given to this suggestion by the Advisory Committee on Tax Procedure, appointed by the Treasury in May 1946.

Chapter 45

SIMPLIFICATION OF TAXES

THE Individual Income Tax Act of 1944 took long strides toward making the income tax comprehensible to most American citizens. And by eliminating a substantial amount of paper work for about 30,000,000 taxpayers it did yeoman service in transforming a trying ordeal into a relatively painless process. While much ground has been gained, we shall doubtless have to be content in the future to travel less rapidly toward simplicity, proceeding merely "leg over leg" as the dog went to Dover.

Simplification need not end when the law is made reasonably understandable to the masses of taxpayers. Steps can be taken to simplify taxation affecting limited groups of taxpayers as well. The businessman is entitled to as much simplicity and certainty as is feasible. Corporations and trusts need not be harassed with unnecessary complexities. Individual taxpayers employing lawyers and accountants deserve all the clarity that can be achieved. There is plenty of work for tax lawyers and accountants for many years to come without benefit of gratuitous complexity. As Mr. Justice Jackson has said: "No other branch of the law touches human activities at so many points. It can never be made simple, but we can try to avoid making it needlessly complex."

Simplification is not a new idea. In an opinion issued in 1918 Mr. Justice McKenna referred petulantly to the 1913 Act as one which "concerns the activities of men and intended, it might be supposed, to be without perplexities and readily solvable by the off-hand conceptions of those to whom it was addressed."[1] Even in the twenties things were in a bad way. By 1927 complaints about the complexity of the income tax reached a crescendo, and the Joint Committee on Internal Revenue Taxation undertook a careful consideration of how the income tax

[1] Lynch *v.* Turrish, 247 U. S. 221, 224 (1918).

could best be simplified. Its report resulted in a rearrangement of the law in the 1928 Act, so that the ordinary taxpayer was supposed to be better able to find at the beginning of the act the material that interested him most. The committee reached the following conclusion:

> It must be recognized that while a degree of simplification is possible, a simple income tax for complex business is not. The task is to simplify the law and the administration for all taxpayers so far as possible, without causing real hardship to those with complex sources of income and various business enterprises who cannot be taxed justly under a simple, elementary law.

The demand for simplification has not been restricted to the territorial limits of the United States. Back in 1915 the late Sir Josiah Stamp, an eminent British authority on revenue matters, was prompted to write:

> There is the usual failure to see that modern life and modern commerce are so complex and diversified that to expect a tax form which shall read like a pill advertisement on the railway, and yet close down upon every case, is asking for the moon.

The same realistic note is to be observed in the famous report of the Colwyn Commission in England, which listened to many pleas for simplicity made by a great number of witnesses, some of them experts in dealing with income tax matters on behalf of the public. The Colwyn Commission found the suggestions made "generally vague and indefinite." The witnesses were

> either unable to give us concrete or definite proposals, or, where they did make proposals, we found that to adopt them would be to do injustice to taxpayers whose peculiar circumstances would not have been recognized, or to expose the Revenue unnecessarily to the risk of loss. We have formed the opinion that in Income Tax matters simplicity is not the sole object to be aimed at, and that the price that would have to be paid for a simple Income Tax could not be justified.

An analysis of the problem of simplification requires inquiry into the causes of complexity. There are three primary causes. The first is the necessity for protecting the revenue. There are always taxpayers and tax specialists who are on the hunt for loopholes. Indeed, one court has

said that tax avoidance is in the nature of mortals. The Supreme Court has recognized the doctrine that "when the law draws a line, a case is on one side of it or the other," and if the case is on the safe side, it "is none the worse legally that a party has availed himself to the full of what the law permits." If we are to prevent tax avoidance, we must have provisions designed to that end. Such provisions, of necessity, are often complicated. They must be complicated because one dares not fire a shotgun into a crowd. They should be precise instruments which do their job of preventing avoidance without injuring innocent taxpayers. It is not enough to attain a degree of precision which a person reading in good faith can understand; it is necessary to attain a degree of precision which a person reading in bad faith cannot misunderstand.

An example in point is the personal holding company provisions. The 1937 tax investigation amply demonstrated the need of preventing the avoidance of tax by the use of incorporated pocketbooks. The Internal Revenue Code contains eleven sections devoted to this one item of avoidance prevention, each of which has required much administrative and judicial interpretation.

The second cause of complexity is the necessity, intensified when rates are high, of giving relief in exceptional cases. An excess-profits tax could have been written very simply, but that very simplicity would have proved disastrous to taxpayers. The Revenue Act of 1942, when the excess-profits rate was 90 percent, contained specific relief provisions for regulated investment companies; it allowed certain public utility companies a credit for dividends paid on preferred stock; and it gave various types of special treatment to mining corporations, coal and iron properties, and timber blocks on account of accelerated output. It granted exemption from the excess-profits tax to corporations mining strategic minerals, and it favored installment basis taxpayers with a special provision. It extended percentage depletion to flour spar, rock asphalt and ball and sagger clay. Among other things, it gave inventory relief and it extended the amortization deduction. Most important of all, it provided for special relief from the excess-profits tax and an 80-percent limitation. It also provided a two-year carryback of unused excess-profits credits and net operating losses. While it increased the rate of tax on capital gains, it liberalized the capital gain and loss provisions.

This is only a partial list of the largess passed out in 1942. Some of these provisions were of doubtful wisdom. Others were made imperative by high tax rates. But provisions for relief, whether good or bad, of necessity add to complexity.

To these causes of complexity there must be added a third underlying cause. Income tax law begins with the statute, but it does not end there. As I have already pointed out, it journeys on into interpretative regulations and many informal administrative rulings. Then the courts make their contribution. The courts quite properly do not restrict themselves to the literal language of the statute. No matter how articulate a statute may be, there is always room for interpretation; in terms of Judge Learned Hand's illuminating metaphor, the meaning of a sentence may be more than is indicated by the words alone, as a melody is more than the notes of music. No degree of particularity can ever obviate recourse to the setting in which all statutory language appears and which all the words of the statute collectively create. To paraphrase former Chief Justice Hughes's remark about the Constitution: We are under an income tax statute, but the statute is what the judges say it is.

The very term "tax simplification" is a vague abstraction, and it is necessary to look behind it for the concrete meanings which it holds. From the standpoint of individual taxpayers simplification means a number of things. It means a minimization of tax arithmetic. It means the elimination of unnecessary records. It means the reduction of tax return forms to a few lines which can be filled in swiftly without digging deep into old papers. But tax forms can be little better than the statute which conditions them. Yet what may be put on a small form conditions the statute.

From the standpoint of the Treasury simplification means something entirely different. The Treasury has its own internal problems. The number of returns which must be handled by the Bureau of Internal Revenue is a vital matter, but it is even more vital that the forms be as simple as possible. The difficulty with complicated returns does not end with their filing; they must be audited. Correspondence may be necessary. Interviews with taxpayers and their representatives may be required. The number of direct contacts with the individual taxpayer, and the clerical work of keeping accounts with him and his employer, are matters of intense concern to a Bureau of Internal Revenue which

desires to afford every aid possible to puzzled taxpayers. Finally, there is the process of judicial review. The simpler our tax laws are made, the easier the whole process of administration and interpretation becomes.

Some people delude themselves into thinking that all of their tax problems would be solved if the language of the statute were less legal. They would abolish verbosity and make the statute read as chastely as the Ten Commandments. This is easier to promise than to deliver. The Socratic method would soon develop a challenge to the simplicity of simple language: Is there such a thing as perfectly plain language? Mr. Justice Frankfurter, among many able commentators, thinks not. He says "the notion that because the words of a statute are plain, its meaning is also plain, is merely pernicious oversimplification."

Some of our worst tax troubles have centered about the few uses in the statute of layman's language. The old insurance section of the estate tax statute is an illustration. The laconic five lines of this provision once seemed simple enough. There were no complicating amendments for more than twenty years. Yet the few words contained in this provision have furnished a remarkable example of what Professor Chafee has called "the disorderly conduct of words." At different times the apparently simple language of the insurance section has meant many things to many men. The one thing the language did not mean, according to regulations and court opinions, was what it seemed on its face to mean. The language, "taken out by the decedent upon his own life," did not refer to the person who applied for the policy and paid the first premium, since such a naïve construction of the statute would have opened the floodgates to wholesale tax avoidance. In the Revenue Act of 1942 Congress, wisely recognizing that simplification is a matter of underlying concept, as well as language, overhauled this provision. It is now longer and its language is more complicated, but its thought is clear. Undoubtedly, it is more satisfactory to both government and taxpayer.

Other people look upon simplicity as a part of fairness. Regardless of whether we should have a government of laws or of men, laws are made for men. Men must live by them. They must understand them, for understanding is the first step toward orderly compliance. In paying taxes men and women are giving part of their time and energy to the government. It is unfair for the government to demand from them the

extra time and energy required to master unnecessary complexities.

Taxpayer good will is a most important consideration. The success of our tax system depends upon achieving the utmost possible simplicity. The American people have shown a remarkable capacity to pay high taxes. This may be due to a developing civic sense which tends to make high taxes have less and less the aspect of "hurt." But the people have also shown a streak of independence, a capacity for protest against taxes they did not want to pay. It is impossible to impose an unwelcome tax by forcibly feeding it to 50,000,000 taxpayers. Taxpayers may be persuaded, but they will not be coerced. They are, after all, to some degree in control of their destinies. Paying taxes gives citizens a very real sense of participation in government. But they must participate with the feeling of partners, not arithmetical slaves. They cannot derive satisfaction from contact with their government when they are befuddled by complexities.

Some taxpayers probably use the word "simplification" in the sense of certainty. They are perplexed by our tax laws because they do not know how much they owe. The statute is filled with provisions which only the expert can understand, and he sometimes has a hard time. Basic policy conflicts are frequent in the statute; the essential pattern of objective is vague. Concepts have changed; the desire to use taxes as an economic balance wheel is a novel tax motive. Taxation has new folkways. The future is a black imponderable. In all this whirl taxpayers glance with nostalgia toward the old certainties they once thought they had, and the present seems more uncertain than ever.

We may go so far along the road to simplification, but no farther. A tax statute cannot be completely immunized from the ravages of interpretation and uncertainty. It is rather like a diminutive charter awaiting the impact of specific events. There is a growing awareness among lawyers and others that statutory interpretation needs to be a dynamic process and that administrative discretion has a legitimate interest in clarifying areas of uncertainty where interpretation may easily incline either way. Words at best are "inexact tools" and are often confronted by the unexpected. A recognition of the delusive exactness of words is good reason for making a statutory scheme as sturdy as possible; there must be agreement on fundamentals and an assurance of consistency.

We need to recognize these truths, but we need also to remember that some measure of uncertainty must always remain, for human ingenuity

is unlimited in its power of conception. Mr. Justice Cardozo expressed doubt whether our tax laws could be much simplified:

> Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.

This perennial problem of degree permeates all legal activity. Tax statutes must be drawn so that they may be as easily understood as possible. But in the rush for simplicity they must preserve their contact with the complexity of modern life; they must be firmly rooted in our fast-moving underlying experience. It is not enough that they be sufficiently comprehensible to reach back to the old; they must also be sufficiently flexible to reach out to the new. For statutory interpretation is more than the discovery of a pre-existing meaning in the mind of the legislator. It is often a search for a meaning that would have been intended if an unanticipated situation had been presented when a bill was drafted. The courts may not say to the legislator: "We see what you are driving at, but you have not said it; therefore we shall go on as before." They must try to find the major premise of the conclusion expressed in the statute, and then obey the policy they see written in the law.

In tax law, as more generally, there are almost always competing considerations. What is simple may not be equitable. What is equitable may of necessity be complicated. In other words, simplicity and equity are often incompatible and we are forced to choose between them. Many years ago the Chinese philosopher Mencius said: "I like fish, and I also like bears' paws, but if I cannot get both together I will let the fish go and take the bears' paws." Like history, philosophy sometimes repeats itself; in modern times Mr. Justice Holmes pointed out that for everything we have we give up something else, and urged that we balance advantages gained against other advantages lost, knowing what we are doing when we elect. A sufficiently desirable objective, either by way of relief or by way of preventing tax avoidance, may be worth some complication. A particular item of simplicity may not be worth the inequity it entails. The question is one of price, and our first choice should be the simplicities that are the best bargains.

Chapter 46

A NOTE IN CONCLUSION

In previous chapters I have stated the facts and principles which demand that we enlist tax—and, more broadly, fiscal—policy to improve social and economic conditions in the "one world" so many people have come to hope may be the world of the future. The realization of that hope is commanded by events which speak louder than any words I could use. Our ability to conquer our own economic problems has become a matter that affects not only ourselves, but the prospects of world peace. American prosperity is the most dynamic factor in the world economy. If we are to lead the world toward enduring peace, we cannot afford to squander our greatness and weaken other countries by our own failures. We have a new responsibility. It is a responsibility to the rest of the world. One of the oldest laws governing man's relation to man touches his responsibility to his neighbor. Although observance of this law is a worthy end in itself, observance at this juncture in world affairs happens to coincide with our own interests. We cannot be prosperous and peaceful for long in a world that is neither. Our destiny and the destiny of other nations are at the end of the same long road.

Almost everyone wishes for economic stability, jobs for all who want them, and higher living standards. Some of us wish harder, and will work harder, for these objectives than others, because we believe more than others that democracy and our free enterprise system would survive another major depression only by the narrowest of margins—if at all. If this is true, the question is whether we can afford to let our economy drift between prosperity and depression as it has in the past, leaving untold human, as well as disastrous economic, devastation in its wake. Of course, there are those who honestly believe that economic fluctuations are acts of God and that nothing can be done about them.

But there are also those who believe that the upward and downward curves of the business cycle can be controlled, if not eliminated. They see the present with the eye of the future; they would muster every available instrument to shape a world of stability and plenty. Taxes are one instrument. They become available once we divest ourselves of a kind of mystical adherence to the maxim that taxes are for revenue only.

The last school of thought—of which I am one of many members—believes that well-planned taxes can materially help us to achieve economic stability. Taxes can be used, as the occasion warrants, to regulate the speed of the economic machine. They can be used to curb inflation or arrest deflation. They can help to expand purchasing power when we need more purchasing power. They can help to stimulate investment when we need more investment. If taxes have these vast potentialities, our choice of taxes—the decisions we make as to what taxes we shall impose and on whom their burden shall fall—has far more to do with the fate of the nation than most people think. Two chickens for every pot will not hatch by themselves. Our economic activities are inextricably meshed. The investor's return depends upon what the consuming public can buy. Mass production, which has made us the world's most prosperous nation and is vital to our future well-being, depends upon mass consumption. In the end, economic expansion depends upon satisfying the desires of all for the things that only the more favored have enjoyed in the past.

What kind of a tax system will give us the greatest part of what we want? There is no short and simple answer to that involved question. And it would be presumptuous for one person to try to spell out an answer in complete detail. But a basic philosophy can be stated, encompassing the broad outlines of the whole without minutely dissecting its parts. And a basic philosophy is what we badly need. Without it our tax system will always be what it has so often been in the past: a series of desperate, extemporized responses to immediate pressures, with no long-run objectives. Without it our tax system will always be out of tune with our economic and business life; in fact, it will frequently work at cross purposes with the legitimate demands of the economy. Without it our tax system will be a mere revenue-raising device which lacks the dignity and utility that can be derived only from more comprehensive and far-reaching purposes. Of course, we must have revenue, but at the same time, and more imperatively, we must have

an economic climate in which taxes will produce revenue without causing intolerable sacrifice.

When inflationary pressures are heavy, taxes should be imposed at rates that will more than meet government expenditures. This procedure will offset the deficits of other periods and, many will hope, allow for some debt reduction. When deflationary pressures are ascendant, taxes should be reduced and, if necessary, a deficit incurred. A deficit caused by tax reduction—particularly in the lower income brackets—is usually the best kind of deficit, because the purchasing power released by tax reduction is used privately, and not by the government. Government spending should generally be a last resort.

Except when inflation threatens, taxes should not unduly discourage the private spending of money. Particularly when deflation threatens, taxes should not unduly discourage the investment of savings. If we tax the smaller incomes too heavily, we tend to dry up spending; there are vast numbers of smaller incomes and they are almost wholly spent for goods and services. If we tax the larger incomes too heavily, we tend to dry up saving and therefore new investment, because a considerable portion of the larger incomes is normally saved. Here arises a dilemma. The problem is to strike a fine balance between conflicting objectives—a balance which, without unduly depressing spending, will encourage investment, so that the economy can expand at a normal rate. The point of balance is a shifting point, its exact location depending upon the economic conditions of the moment. It will be well, as we wrestle with this problem from time to time, to remember that high taxes are not the only deterrent to investment. A tax system which weakened markets by placing too great a burden upon consumption would also drive investment funds to cover. For businessmen produce in order to sell; if they cannot sell, they will not produce. In the long run, the profit that attracts investment funds must come from a public that is able to buy what the businessman offers for sale.

One function of taxes is to counteract undue concentration of wealth. If the nation's wealth flows into the hands of too few rather than into the hands of the many, the resulting amount of saving will be greater than can be absorbed. Our economy can take only so much of this sort of thing before it has a violent convulsion. In this area we need a new perspective. The estate tax is the traditional medium for diluting concentration of wealth. But the estate tax produces less than one-sixtieth

of our revenue and has become an inadequate solvent. High bracket income taxes, on the other hand, are a valuable supplementary agent for this purpose.

But, here again, we must take care that we do not try to do too much. Income taxes can be high enough to force some of our ablest producers into comparative idleness. The deflection may have compensating cultural advantages, but the accompanying disadvantage to the economy may be disproportionate. The profit motive is a wholesome stimulant in a capitalist society. It should not be permitted to run riot, but it should be kept alive and vigorous. Tax rates hardly below war levels may well endanger the profit motive in peacetime, and should be reduced except, perhaps, in the highest brackets.

Taxes should be fair. They should be fair because any other kind of taxes would offend a deep sense of equity most Americans possess. They should be fair because unfair taxes impair the morale of our taxpaying citizens. When windfalls are given to some, an added load is placed upon others. Resentment is bound to follow. The success of our tax system depends upon the co-operation of taxpayers more than is commonly supposed. Willing taxpayers are taxpayers who are satisfied that they are bearing their fair share, and no more, of a tax burden intelligently distributed to promote the general welfare.

Fairness is a vague word. But in concrete application the meaning of the term usually becomes clear enough. Certainly, it is not fair for some citizens to escape tax on large amounts of interest upon state and local securities, unless that result is demanded by constitutional limitations—which I do not believe it is. Unless the national interest demands increased production which can be secured in no other way, it is not fair that the owners of certain mineral properties, including oil lands, should have the benefit of a special deduction for percentage depletion when that deduction is not granted to owners of other types of property. It is not fair that the citizens of nine community property states should pay less income taxes than the citizens of the thirty-nine other states. It is not fair that in all the states many individuals with accumulated capital can secure, by the use of various trust devices, advantages which cannot be realized by taxpayers who are in the less fortunate position of having to earn their incomes.

Insofar as modern life permits, taxes should be certain. The statute and the regulations should say what they mean and mean what they say.

They should not be constantly changed; a large part of the process of necessary change can be carried out gradually in the course of interpretation by the Treasury and the courts. Adjustments to current economic conditions can be made by variations in the rate schedule. But, as adults, we should recognize the impossibility of returning in taxation, as in other things, to the fixed certainties we thought we had in the early years of a century that is nearly half gone. We cannot escape the fact that we live in fluid times, or the requirement that our taxes reflect the rhythm and pace of those times. On occasion, progress will even require experimentation; our country began as the greatest experiment of the eighteenth century. In the unforgettable words of Mr. Justice Brandeis, a man who was not afraid of novelty: "If we would guide by the light of reason, we must let our minds be bold."

This general philosophy indicates that we should rely principally upon a progressive individual income tax based upon ability to pay. But this hackneyed formula needs a new orientation. It has become embedded in irrelevant moral connotations. We are prone to forget that it is also sound economics. The intelligent application of the formula would preserve purchasing power and limit saving to absorbable amounts. Income tax rates and exemptions should be sufficiently flexible to meet shifting economic conditions. In the interests of fairness and increased progression, loopholes should be closed. Administration should be strengthened; even the best tax law cannot rise above bad administration.

Some modifications should be made in the corporation tax to eliminate defects and remove economic restrictions. To encourage risk capital, distributed corporate profits should receive differential tax treatment, but the differentiation should be made in a manner which protects low bracket taxpayers and small corporations. The loss carry-back provisions should be eliminated and the two-year carry-forward of net operating losses should be extended to at least five years.

Our social security program should be expanded and the method of financing benefits should be altered to increase purchasing power in the groups where living standards are lowest and needs are greatest. Our whole economy would benefit if part of the costs were met by government contribution.

Our estate and gift taxes should be integrated with each other and correlated with the income tax in such a way as to close avenues of

avoidance and prevent overlapping. Rates should be raised and exemptions lowered, and a special status should, perhaps, be given to an inheriting husband or wife. It is in the transmission of property from one generation to another that the estate tax serves its most valuable purpose. Such a strengthening of the estate and gift taxes would not appreciably affect incentives to consume and invest.

Excise taxes should be handled with careful regard for the relative importance of various taxed commodities to the maintenance of a prosperous economy. A general sales tax should not be imposed. As a part of a well-rounded program for world economic growth, customs duties should become less and less important.

We can embrace a tax program of this order only if we accept the concept that the role of taxes in our economy transcends the ordinary revenue-raising function. We need not be misled by the bogy of "a planned economy." As a natural reaction to wartime controls, we have lately developed the habit of looking under that bed too often. One thing far worse than an economy resulting from a reasonable amount of planning is a completely unplanned economy, haunted by the terrifying specter of widespread joblessness in the event of another depression. The central tax question of the present and the future is whether we shall plan resolutely in advance when we can shape events, or hysterically in the panic that comes after we have lost control of the economic steering gear. A nation needs to plan its taxes just as a businessman has to plan his business and as individuals have to plan their affairs. Any other doctrine would deny the plain truth that it is wise to prepare today for the needs of tomorrow.

It is hard to believe that some of the most violent objectors to planning are as out of sympathy as their words sometimes indicate with the need for prudent planning for the future. They must realize that planning had a great deal to do with the recent preservation, as well as the development, of the civilization that Americans are fortunate enough to enjoy today. There are many who doubt if that enjoyment will last for long unless we plan now as we have never planned before.

Taxes are no exception to the general rule that we live intelligently only by looking ahead to the long-range results of what we presently do. A piecemeal, tinkering method of tax revision can yield only jumbled results. There is a peculiar need in taxation for seasoned judgment and mature perspective which can appraise all changes in the light

of a complete pattern of Federal taxation. No less comprehensive approach will suffice, for taxes at the rates necessary to meet present-day government expenditures must have a profound effect upon our daily lives. To impose them only for immediate revenue without consideration for what they will do to our economy and without regard for their social consequences would be the most costly mistake we could make at this critical period of American history.

Our tax planning must be done in the democratic way. In the process sincere differences of opinion will arise. Many private interests will compete with the public interest. Immediate gains will blind some to the ultimate advantage of subordinating their private interests to the public interest. But there must be "free trade in ideas," for, as Mr. Justice Holmes once told us in a context far removed from taxation, "the best test of truth is the power of the thought to get itself accepted in the competition of the market." That, at any rate, is the theory of the Constitution from which our Federal Government derives its power to tax the people of all the states. That power to tax does not involve the power to destroy, as was loosely said by a distinguished jurist many years ago, but rather the power to fulfill a better destiny.

The task of building a sound tax system will be hard and long. It is not a partisan job; it is not a job that will be completed by any one Congress. There will always be things left to do, if we have the wisdom to benefit by the new insight which experience can bring to open minds, and if our tax system is to fit the changing economic and social needs of each succeeding generation. Every American citizen shares in the responsibility. Some will be pessimistic as to the outcome of the application of the democratic process to so complex a subject as taxation. Some will be full of complacent optimism resting on satisfaction with things as they are. The useful attitude will be a determination that what is wrong now will be set aright, fortified by an unswerving confidence that the final compromise of all conflicting forces will be a tax system intelligently designed to make a continuously prosperous America.

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